TAX REDUCTION PROPOSALS

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TAX REDUCTION PROPOSALS

TUESDAY, MAY 19, 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, Hon. Robert J. Dole (chairman of the committee) presiding.

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

The CHAIRMAN. We are honored this morning to have our colleague, Senator Hollings of South Carolina. There will be other Senators here. We have continuing a series of hearings on proposed tax reduction.

We have a number of outstanding witnesses today. I see a number here already. Indeed, I count about 17 this morning. [Laughter.]

So, please be seated where you wish.

[The prepared statement of Senator Hollings follows:]

PREPARED STATEMENT OF SENATOR ERNEST F. HOLLINGS

Mr. Chairman and members of this distinguished committee, I appreciate your willingness to listen to my views on our economic problems and how we as a nation can best deal with those problems. I do not want to discuss today each of the very many pieces of legislation which have been referred to this committee, but rather provide a broad plan for fiscal policy and outline particularly the direction I believe this committee should take.

Mr. Chairman, the Budget Committee has just finished its conference report on the Federal budget for the 1982 fiscal year, completing a process which began some months ago. I wish to report to you today that we have provided for substantial increases in defense outlays, while saving some $36 billion in 1982 alone from other Government programs We have also provided room in the budget for President Reagan's tax program, thus granting the "flexibility" that this committee desired. I am here today to ask that you use that "flexibility" sparingly.

While the Budget Committee has made large savings in Government programs, there should be no doubt in anyone's mind that there will be a large budget deficit in fiscal year 1984. This occurs because the economic assumptions upon which the budget is based are not realistic; economic growth is unrealistically high while inflation and interest rates are unrealistically low, using more reasonable economic assumptions would add dramatically to Federal outlays and seriously imbalance the budget. Instead of a balanced budget in 1984 three will probably be a deficit on the order of $50 billion. We need to proceed more deliberately toward the goal of a balanced Federal budget.

The responsibility for erasing this deficit must now fall on revenues and on this committee. We must recognize the likelihood of large Federal deficits and reduce the size of the tax cut accordingly. Beyond that, the tax proposals need to be targeted to areas which can measurably improve our economic performance.

Tax reduction needs to be directed toward improving productivity by increasing the incentives to save and invest. Productivity growth in this Nation has deteriorated markedly in recent years. Between 1950 and the mid-1960's, productivity in-

creased annually by nearly 3 percent and accounted for over two-thirds of the annual growth in our capacity to produce goods and services. In the past 3 years, by contrast, productivity has declined.

The lack of productivity growth has a dramatic impact on our nation and on the Federal budget. Productivity growth is the major contributor to a rising standard of living. If people cannot produce more there is no way for them to consume more or for business to invest more. These facts are well known to this committee. What is perhaps less well known is the impact that slow productivity growth can have on the Federal budget.

Slow growth in productivity increases the costs of production and inflation and thus leads to higher Federal outlays and interest payments. The slower productivity growth implies slower economic growth over the longer term. The taxable income base is not likely to rise rapidly enough to pay for a portfolio of Government programs reflecting the "graying" of the population and the increase in defense expenditures. The tax rate will have to rise to reflect these changes of else we will have to accept further spending reductions or a large Federal deficit. This is a rather sober view of our economic prospects and one which we in Congress have been reluctant to face.

How can we improve our economic situation? We can begin by being more realistic about our economic prospects and adjust Federal programs where necessary, for example, by altering the method by which social security, and civilian and military retirement programs are indexed for inflation. But in addition, we can keep our eye on productivity and enact a tax program which will improve on that most fundamental fact of economic life.

There must be three primary ingredients to the tax program, (a) incentives to work and save, (b) incentives to invest, and (c) A reduced Federal deficit. We need greater work effort to directly raise our productive capacity; we need greater savings and investment to stimulate capital formation and productivity growth; and we need a reduced Federal deficit so that massive Federal borrowing requirements do not interfere with private financing requirements for capital investment.

My tax proposals contain these three essential elements and thus can contribute in an important way to reducing the Federal deficit and lowering the rate of inflation. Many of these propsals were endorsed by this committee last year.

TAX REDUCTION PROPOSAL

[Dollars in billions]

	Fiscal year—			
	181	1982	1983	1984
Individual	−$0.7	−$7.7	−$29.2	−$42.9
Marriage penalty	−.2	−3.8	−7.2	−8.6
$1,000/2,000 interest and dividend exclusion	−.5	−3.9	−9.0	−12.3
Personal rate cut of 5 percent in 1983			−13.0	−22.0
Business	−4.3	−13.7	−21.4	−28.2
2-4-7-10 depreciation	−4.3	−13.7	−18.6	−19.0
Corporate rate cut to 40 percent in 1983			−2.8	−9.2
Total tax reduction	−5.0	−21.4	−50.6	−71.7
Supply-side incentives as proportion of total (percent)	100.0	100.0	74.0	70.0

These tax proposals would accomplish two objectives, (a) to stimulate the supply side of the economy and (b) to lower the personal tax burden. In the first 2 years of the program all, 100 percent, of the tax reductions are targeted toward those areas where supply-side effects can be maximized. Supply side incentives refer to direct incentives to work, save, and invest, only in the out years, 1983 and 1984, are there reductions in personal tax rates because it will not be until that time that productivity can be expected to rise more rapidly so that we can afford those kinds of tax cuts.

The business tax custs are put in place immediately. The 2-4-7-10 depreciation proposal was passed by the Senate Finance Committee last year. In addition, I have proposed a reduction in the corporate tax rate from 46 percent to 40 percent

beginning in 1983. This provides for an attractive future business climate and thus will have a positive effect on investment spending now.

Let me speak briefly on each of these proposals. About 40 percent of married couples currently pay more income taxes than they would if they paid taxes as individuals. In 1981 my proposal grants a 5-percent tax credit against the first $30,000 of earnings of the lesser earning spouse. In 1982 this credit would be raised to 10 percent. This proposal would focus tax reductions on the supply side of the economy by removing part of the disincentive to work of the secondary earner in the family. It would also lower the tax burden in such a way that supply is increased, thus placing a moderating influence on inflation.

My proposals would raise the current interest and dividend exclusion of $200 for single returns and $400 for joint returns to $1,000 for single returns and $2,000 for joint returns. This again focuses tax relief on savings, and thus the supply side of the economy. It reduces the bias in the tax code that favors consumption and helps to provide the savings necessary to finance additional investment and hence growth in productivity.

The personal tax burden is rising due to inflation. This proposal would reduce personal tax rates by 5 percent beginning in 1983. This, partially, addresses the question of tax burden, but places the relief in 1983 when productivity has hopefully improved.

I would like to support the depreciation proposal (2-4-7-10) that was adopted by this committee last year. There are a number of benefits to this proposal. The incentives are effective immediately and not phased in slowly as in the administration proposal. We need to get investment expenditures started quickly and the 2-4-7-10 proposal would do that. Additionally, this proposal would not provide benefits which are greater than could be obtained by depreciating capital assets in the year purchased. The administration (modified 10-5-3) proposal would do that as well as severely distort the after-tax incentives to purchase different types of capital equipment.

I would also reduce corporate tax rates from 46 percent to 40 percent beginning in 1983. This measure is a further incentive to business to invest and will contribute to productivity growth. It provides for future tax relief. Since the profits made then from current investments will be taxed at a lower rate, this will stimulate investment now.

These proposals capture the essential ingredients needed to promote savings, investment, and productivity. These proposals differ in both structure and size from those put forward by the administration.

COMPARISON OF TAX PROPOSALS

[In billions of dollars]

	1981	1982	1983	1984
Individual:				
Hollings	-0.7	-7.7	-29.2	-42.9
Administration	-6.4	-44.2	-81.4	-118.1
Business:				
Hollings	-4.3	-13.7	-21.4	-28.2
Administration	-2.5	-9.7	-18.6	-30.0

The major difference is in the tax cuts for individuals. My proposal is considerably smaller, and is, in fact, only one-third as large as the administration's by 1984. But what can I claim for my proposal that the administration cannot?—A balanced budget by 1984 using realistic economic assumptions. It is essential for this Government to establish a fiscal policy that is at least approximately targeted on a balanced budget. A balanced budget would considerably relieve treasury borrowing requirements in money and capital markets and would make savings available to finance investment, productivity, and economic growth.

My tax proposals differ from the administration's in another respect; mine are targeted while theirs are across-the-board cuts of 30 percent in three years. Mine is a reduction in the marriage penalty and increased incentives for saving. The Federal Government is faced with continuing large deficits and thus cannot afford large across-the-board cuts. Rather, the cuts must be targeted to areas where the supply-side influences are largest. Across-the-board tax cuts squander the resources available for a more effective fiscal program. It is necessary that fiscal policy set as a

target a balanced budget by 1984 and that the tax cuts be effective as they can be, dollar for dollar, in stimulating savings, investment, and productivity.

One criticism made of my proposals is that with our current rates of inflation, individuals, will be pushed into higher and higher tax brackets at a faster rate than my tax cuts will reduce those rates; that actual tax rates faced by Individual taxpayers will increase. Let's be honest about this—that is true. Inflation is a powerful generator of tax revenues. But the more important issue is whether we as a nation can afford the tax cuts necessary to keep the tax burden from rising.

I am not at all politically embarrassed by the prospect of rising tax rates. The Senate has reduced federal outlays by substantial sums. Unless the President is willing to request additional cuts—that is, beyond those specified as well as unspecified in the budget resolution—we must face rising tax rates in order to balance the budget. Higher taxes are necessary to pay for the social services and military expenditures that have been proposed. We must get our fiscal house in order and that demands a balanced budget, and unfortunately, higher taxes as well. A large across-the-board tax cut at this time is a luxury this Nation cannot afford.

This committee proposed last year a tax measure which in some respects is similar to mine. In fact, many of those proposals I have accepted. Moreover this committee's proposals would cost about $76 billion in 1984 while mine would cost $72 billion. Thus, each proposal would essentially balance the budget by that time. Nevertheless, one aspect of your proposal concerns me very much.

Your proposals and those of the administration cost roughly $51 billion in fiscal year 1982, while my proposals cost only $21 billion. There are a couple of reasons why this difference is important.

First of all, we need to recognize that while my tax proposals are directed toward improving incentives to work, save, and invest—the supply side—there are demand-side effects as well. Anytime people receive tax reductions their after-tax incomes rise and they will spend more on goods and services and add to aggregate demand. There is no set of supply-side tax proposals where the effects on supply are larger than the effects on demand. However, we can make that unfortunate situation as favorable as possible. My proposals would do that. But because demand-side effects are always present, this committee needs to be mindful of the size of the tax cut in 1982.

Second, a major danger that I see, and the reason why my proposal provides for a smaller tax cut in 1982, is the potential for a dramatic collision between fiscal and monetary policy. The Federal Reserve is committed to a program of restraining the growth in the monetary aggregates as an essential ingredient in the fight against inflation. For some time now the Federal Reserve has been the only anti-inflation game in town. The Fed cannot do the job alone. It is time that tax and spending policies became an equal partner in the fight against inflation. This requires a commitment to an honestly balanced budget and a commitment to a small tax cut in fiscal year 1982.

A large tax cut, and particularly a large demand oriented tax cut as the administration has proposed, will present considerable difficulties for the Federal Reserve because of the increase in Treasury borrowing requirements. If the Fed buys too much of the extra Government debt, monetizing part of the debt, it risks an inflationary surge in the money supply. If the Fed does not buy part of the extra debt then interest rates will have to rise significantly to entice private citizens to purchase this Government debt. In a very real sense this committee must decide whether the economy is to receive tax relief or interest rate relief.

Interest rates are important for another reason—their effect on the supply-side of the economy, investment and capital formation.

Fiscal policy must be directed at stimulating investment and growth in productivity. Two factors are particularly import (a) tax incentives and (b) interest rates. Improved tax incentives will stimulate investment spending, but higher interest rates will reduce spending. We must have stable or lower interest rates to enhance the supply-side incentives in the tax proposals. With a large tax for indivduals the higher interest rates that would occur could totally offset the economic effects of improved tax incentives. The Government would then be left with a large Federal deficit and no extra investment spending to show for it. It is vital that whatever this committee does in the way of individual tax cuts, they not be so large as to undermine the very supply-side incentives that we all agree are necessary for this Nation's future growth and prosperity.

This committee must address three very broad issues, first whether fiscal policy will be targeted toward a balanced budget in 1984, second, whether individual tax reductions will be across-the-board or targeted toward areas where they can be most effective, and third, whether the tax and spending program will lead to lower or higher interest rates. My proposals are clear and straightforward. I favor a balanced

budget, targeted—supply oriented—individual tax cuts and lower interest rates. I do not need to further impress this committee with the importance of their decisions.
I appreciate having this opportunity to express my views on this subject.

STATEMENT OF HON. ERNEST F. HOLLINGS, A U.S. SENATOR FROM THE STATE OF SOUTH CAROLINA

Senator HOLLINGS. Thank you very, very much, Mr. Chairman. I want to thank you and Senator Packwood and Senator Grassley, and all the colleagues. We hear each other enough. We have debated the tax cut pretty thoroughly on the Senate floor. I do appreciate the opportunity to emphasize the added responsibility, I believe, that the Finance Committee must now face.

Both yourself and Senator Packwood have served on the Budget Committee. Senator Grassley and I are presently serving there together.

When we establish a figure for revenues or tax cut amounts, the Finance Committee has been given its figure by the entire Congress, the House and the Senate. The upper limit for the tax cut in fiscal year 1982 is $54 billion. We need to act prudently within that $54 billion, to focus the cuts on supply so that it stimulates investment and savings. You and I are both very familiar with these arguments. But that's not enough, for the simple reason that the budget itself is out of kilter.

We've just gotten through the budget conference of both Houses. In that particular conference we cut spending, as you well know, our favorite is spending cuts. We led the way. Senator Domenici and myself cosponsored Senate Resolution 9 to cut spending by $3 billion more than that recommended by the President.

And, we're very much for the defense increases, but in assimilating the budget itself as a document, we were not straightforward with respect to interest rates, inflation rates, growth rates, and the other factors that go into the makeup of a budget, jimmying it around, if you please, trying to make it balance by 1984.

I was very much disturbed by the process this year. We didn't correct that situation when we got in the conference with the House. Mr. Chairman the budget now requires spending cuts of $36 billion. That's fine business.

But, if you increase, which they have, spending by $36 billion, then it's pretty well a wash. In other words, we have increased defense approximately $26 billion, the 1982 figure over 1981, and by another $10 billion to cover the uncontrollables such as social security and, cost of living adjustments in other indexed programs.

So, while we've cut spending $36 billion, we've added $36 billion. So that pretty well cancels it out.

Then we come around and give a $54 billion tax cut. We made room for the Kemp-Roth proposal. My hope this morning, in appearing here, is to try to persuade the Finance Committee that they should not use all of the $54 billion.

There are many different arguments for stimulation or for incentives for savings.

But, if you accept the $54 billion tax cut, even if you can put it solely on the supply side, you are bound to have about a $60 billion deficit next year. In fiscal year 1981 the deficit will also be around $60 billion.

In 1982, you have made all the spending cuts; you have sent government back down to the people, in the form of State bloc grants; and you have started to control the uncontrollables. If you end up with another $60 billion deficit, you get right to the point that was being made by the distinguished Chairman of the Federal Reserve yesterday in his conference with the President of the United States. My presentation this morning supports the views expressed by Chairman Volcker.

Chairman Volcker has said that the administration and Congress must narrow the deficit to help the Fed contain money growth without higher interest rates. That's all we're worried about. All we're really worried about is deficit spending. The debate in the Finance Committee, should be on whether we need supply tax cuts or demand tax cuts or both.

You can just be King Solomon and write out all the fine tax laws that stimulate savings and investment incentives, but if you have a cut of that size; namely the $54 billion Kemp-Roth, then you're bound by simple arithmetic to have a very, very large deficit next year, which makes for higher interest rates.

And, therein is the problem. We've been deficit financing for the last 10 years. Over a 10 year period, we've run up over a $400 billion cumulative deficit between 1971 and 1981. We've had tax cuts, they haven't been the mammoth kind, but we've nibbled away at it.

We had the tax cut of 1969, we had the tax cut of 1971, we had two tax cuts in 1975, we had a tax cut in 1976, a tax cut in 1977 and 1978. Each one of them we sold, because I was participating in those particular debates, on the argument that productivity would be improved.

These tax cuts were all going to create productivity. Here we come again, with the same approach. We're going to improve supply side incentives and we're going to create productivity. You must know that you're really going to be creating a mighty, mighty large deficit.

You're continuing the deficit spending. As a result the high inflation rates are bound to continue and eliminate many of the incentives that you have provided with tax cuts. The plan I've submitted in my statement borrows literally from the Finance Committee work of last summer and fall. My proposal includes the elimination of the marriage tax penalty, the $1,000 and $2,000 exemption from interest earned or dividends received, and the 2-4-7-10 depreciation proposal which is much more equitable and immediately provides incentives for business investment.

Those are really the Finance Committee proposals of last year and you could adjust those as you see fit.

But, what I'm talking about is the size of the cut itself. Every one of the economists say it's got to be initially at about $20 billion. Yes, we have cut $36 billion in spending, but we have also increased spending by $36 billion and now you've got an additional potential revenue loss of $54 billion.

And it's like an insurance company looking for a new slogan. A friend I had down in South Carolina and the winning slogan we suggested to him was that Capital Life will surely pay, if the small print on the back don't take it away. [Laughter.]

And, here it is, you go and work like the dickens and report one of the wisest and most far-sighted tax cut proposals all on the supply side. There's rejoicing everywhere, but in the end we have not produced a good budget. It's not your fault. But, you've got to realize it because you are our only chance, our last hope to eliminate deficit spending, and reduce the high interest rates that are actually going to cancel out the good incentives that I'm confident that this committee will include in this bill.

I appreciate very much the privilege of appearing. I'll be glad to try to answer any questions that you have.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Thank you, Mr. Chairman.

We want to tilt toward productivity and away from consumption. Is that what you want to do?

Senator HOLLINGS. Right.

Senator PACKWOOD. Again, taking the less informative measure creating competitors, none of them allow deductibility of consumer interest. Why not do the same thing?

Senator HOLLINGS. We could.

Senator PACKWOOD. Which is a heavy tilt away from consumption.

Senator HOLLINGS. Right.

Senator PACKWOOD. Do you have any objections to it?

Senator HOLLINGS. No, if you can fit it in. My concern is the size, not the content.

Senator PACKWOOD. That picks up a lot of money.

Senator HOLLINGS. Right.

Senator PACKWOOD. It's a revenue raiser.

Senator HOLLINGS. You folks are far more expert than we are on the Budget Committee on these tax matters, and you know exactly from your hard experience over the years, listening to all the witnesses, exactly what is likely to occur.

But I would think and hope that you look at the size of the particular tax cut and try to phase it in. In 1962, it's forgotten President Kennedy first put in his investment tax credit for business, and then after that was phased in, then they got across-the-board in 1964.

I'm for a tax cut.

Senator PACKWOOD. On the marriage penalty cut, is it your assumption that at the moment it's a significant disincentive to work.

Senator HOLLINGS. Exactly.

Senator PACKWOOD. Third, on the savings rate. I will have the figures here from my staff in just a moment—I left them in my office, we're forever having this Japanese savings rate thrown in our face of 25 percent. Americans have got to increase their savings rate.

I only recently realized that America has not traditionally had a high savings rate. Apart from World War II, where we were buying Victory Bonds and War Bonds, we average around 7½ percent, our high was about 8.4 percent. We're down to a low now of 4.8 percent. I've wondered how we managed to have such tremendous expansion in the 1950's and 1960's if the savings rate, and by this I really mean the passbook savings rate, was really a key.

And, until I had the Library of Congress finish the study for me, in which I realized that most, especially in Asia, to a lesser extent in Europe, but most foreign business expansion to a much greater degree than ours is financed by bank loan or debt, whereas our cultural history is financing by equity, stock.

If we have a 7½ or 8 percent savings rate, we will have adequate money to do the normal things we have done with savings, which is housing, and at least initially small business, although it interested me that when small business starts to grow they then normally convert to capital stock and they grow more by equity than they do by debt.

I wonder if we need the $1,000-$2,000 savings exclusion. I wonder if we need it because it's not our historical way of financing business, and if we wouldn't be tilting more toward savings, assuming it works, than we need to do.

Senator HOLLINGS. Well I don't know that that study touched upon it, but I would suggest that we never had to worry about the high inflation rate before. We didn't have until this recent last 4 or 5 years. Between 1959 and 1964 the average inflation rate was 1¼ percent per year.

It's been averaging 10 percent in the last 4 years. And that's a big factor in the Government itself. I know the rhetoric about 26 years of Democratic Congresses, but the fact of the matter is that all Congresses up until about 1970, acted rather responsibly. There were not these large deficits.

In fact, I used the $400 billion figure for the 10 years cumulative deficit from 1971 to 1981, in the 20 previous years from 1950 to 1970, the cumulative deficit there was only $74.7 billion.

So, they all paid off. The budget deficit got a little over the line, in some years. The last budget we balanced, the Senator and I were together, was in 1968-69. We actually got a surplus of $3.2 billion.

But, in the last 10-year period, we just went wild and we got up to these $45-$60 billion range. And we got a $60 billion deficit this year. You can do the best job you can within the $54 billion, and you will still end with a $50 to $60 billion deficit. That's going to be the tragedy of it, unless you try to pattern whatever you do within a $20 billion range, and then let it grow in the out years.

There's no objection to this 3 year tax cut. Business has got to be able to project and invest on the reliance on what the policy is going to be, and I don't think Democrats or Republicans really are worried about that, or losing the power by passing a 3-year bill.

That's not the debate. It's taking $250 billion on the Kemp-Roth in the next 3 years across the board. Where is anybody hardly going to make that up. That's too big a gamble. Everybody's not going to save, and everybody's not going to run down and buy stock.

Senator PACKWOOD. I think you've used up my 5 minutes. [Laughter.]

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

Fritz, under the tax reduction proposals you favor as far as personal income tax is concerned, would the people who pay taxes down the road 2 or 3 years end up paying more taxes than their present—than they would otherwise pay, or less taxes, or is that

not a significant factor for us to consider as far as you are concerned.

Senator HOLLINGS. That is the significant factor, and the question is what is increasing your taxes. Of course, the major culprit is inflation itself.

That's what's been increasing the tax take. The actual rate has not changed by law. We haven't had a Senator come in here and introduce a bill to increase taxes. The inflation, and it's the fiscal policy set by the Congress itself that is causing the inflation, causes the increase in taxes. Inflation is very, very material to what we're trying to do.

And that's my whole point. You can't solve it all. We asked the economists last year, within the Budget Committee, could you really cut the spending and increase defense and cut the size of Government all in 1 year. They said, no, one works against the other. It just cancels out. They said you've got to take it in an orderly way. Bring that deficit down by half in the year 1982. Aim us in the right direction so the budget will be balanced by 1984. Then they'll pay less taxes.

Senator GRASSLEY. So, when we're done with the bill here, you want us to pass a bill that will have the individual taxpayers, the working men and women of America in 1982 and 1983, have a less total tax bill than otherwise is automatically going to happen.

Senator HOLLINGS. Exactly.

The CHAIRMAN. Senator Long.

Senator LONG. Pardon me for not being here when you presented your statement. I was at that point, having breakfast. My panel will be last on the program, they're going to testify for employee stock ownership. As you know, I'm interested in that subject. Whatever I can do to encourage it, I'm going to do. As a matter of fact, we didn't discuss it at that meeting, but I think I ought to say it, that the one benefit that you can offer employees that will not be inflationary, will not increase the cost to the employer, but that will increase productivity, will deem more cooperation between labor and management.

We'll all strengthen capitalism, and we'll help our system to provide workers with stock in the company, that won't inflate the cost at all. And, there's nothing in this bill about that, and if I can, Senator Hollings, I'm going to put something, offer something, that my colleagues might vote it down, but they'll have a chance to vote it down.

What concerns me is that there's nothing that we haven't discussed in the—Here we've all been talking about doing these great things we're going do and talking about what Truman and Roosevelt and all these great Americans did down through the years, but we have about the same distribution of wealth we have in America—in relative terms, not who owns what percent, but the same distribution of wealth today that we had back when Herbert Hoover took over from Calvin Coolidge, or when—or go back and take it when whoever came into the office at the turn of the century, McKinley or Theodore Roosevelt or whoever.

So that, I just think that we ought to be doing something to strengthen our system. You look at what the Japanese are doing—employee stock ownership is good—but they do take a great inter-

est in educating the employee on where he stands, what his position is with management, and gaining cooperation and collaboration and, well a better understanding and I'd like to—at the end if I can—I'd like to say something about that. And, you don't object if we work something in the bill about that, providing it meets your objective. I'm not asking—I just think that we can find something in here that—enough room to do something to make capitalism more democratic while we're doing all this. It's going to make a lot of rich people richer, and I'm not against that, that's fine, just make investments and do what they think is good for them and good for the country plan, but do you have any objection if we try to cut the workers in on this melon.

Senator HOLLINGS. Not at all, Senator. I've cosponsored it with you. The question is again whether we've got enough room. It's very simple, your wife is going out to buy an Easter outfit and you've got a $100 to spend on it. But, she gets a bargain with the shoes and she gets the dress from an outlet and then she gets the hat at a sale and she's saved on everything, but when you look at the bill its $250. [Laughter.]

And, you only had a $100 to spend. I think this Finance Committee has got to first determine how much its got to spend, and if they determine that wisely to really come down from that $54 billion that we gave you. You won, you've got your flexibility, but I'm praying you don't use it.

Senator LONG. I have one more question. What is the basis for your statement that President Truman gave us a balanced budget 4 years in a row? I was around here in the Congress at that time. That's not how I recall it.

Senator HOLLINGS. Oh yes, it wasn't 4 years in a row, he had a little more than that, but 4 of the 5 years.

Senator LONG. Are you applying the present consolidated budget approach started by Lyndon Johnson, and then recomputing what Harry Truman did against that approach, or are you saying he gave us a balanced budget based on the approach that existed when he was President?

Senator HOLLINGS. I didn't look at that consolidated budget, I know when Lyndon came in, he started putting everything in on the budget to cover up and use the trust funds. [Laughter.]

And, that was a nice gimmick at that time, but generally, you had fiscal responsibility, we were all aware of it, the people were. They just can't understand how everybody is talking, that's how Jimmy Carter got elected. He was zero-based budgeting. He was going to balance the budget. He came up here and we got more deficits. That's why they're so disillusioned. I don't want to disillusion them again in 1982. That's my worry right this minute.

The President's got a good program, our favors increase in defense, he's cutting the regulations, he's cutting spending and he's cutting taxes, but he can't on that tax cut use that $54 billion flexibility or else we're up a creek again.

We've got the same old deal again of another $50–$60 billion deficit next year.

Senator LONG. Well, I did my best to ask you two questions in my 5 minutes.

Senator HOLLINGS. Oh, that's all right.

The CHAIRMAN. Thank you, Senators.

Senator Byrd.

Senator BYRD. I yield Senator Long my time. [Laughter.]

I have no questions.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Fritz, I'm just curious why you don't agree with some of the administration—that we need a deficit, that is we need a massive tax cut in order to stimulate the economy and so forth. More precisely, why do you disagree with that point of view?

Senator HOLLINGS. Just look at the morning headlines the prime rate has gone up to 20 percent. I don't think you need stimulus. Right there, that's inflation, that's high interest rates.

Federal Reserve has got one or two courses. They can monetize that debt, create a bigger debt for the fifth or sixth—I don't know how many years in a row it is now, I guess about 9 years in a row, and this is the 10th year. So you're going to have a $60 billion deficit and you create another $50 to $60 billion deficit. A Fed can go out and buy that debt and therefore inflate the currency or they can hold back, tighten the money supply and then interest rates are going to have to rise so that private capital will buy that debt.

One way or the other it's a disaster, it's either inflation or high interest rates, that's why. I don't want to accept those results. I've heard that before. You know there's an old saying, you've talked again and again about productivity. We've had seven tax cuts in the last 10 years.

This Finance Committee has not been lethargic, it's been very diligent, and we've all had all kind of tax cuts. We had it for small business in 1978. The President's talking about it, we cut taxes then, we cut capital gains. It worked. But the fact is we've lost those revenues and there's no education in the second kick of a mule. We're about ready for the eighth kick of a mule in the last 10 years.

We're going to do the same thing over. We're going to talk about productivity, we're going to talk about stimulation and then we end up with a bigger deficit and higher interest rates, and then go out and blame the Federal Reserve.

Senator BAUCUS. Well, I asked the question because a few days ago Alan Greenspan said bond markets are not collasping, not because of Wall Street's lack of confidence over the administration's 10-10-10 proposal, but rather because Congress hadn't cut spending enough. I'm just curious——

Senator HOLLINGS. Can I answer on that Senator?

Senator BAUCUS. Yes, you can.

Senator HOLLINGS. On the matter of cut and spending, when we voted on April 9, Senator Grassley was there. Three Republican Senators voted against that budget resolution, because it was out of balance. It promised a high deficit.

Then they went in to cut some more spending during our Easter break. And Dave Stockman brought over his black notebook to the Republican leadership on the Budget Committee, and he opened it up for the additional spending cuts.

And, No. 1 out of the box was to totally eliminate State revenue sharing. No. 2 was totally eliminate elementary and secondary aid to education, and Senator Domenici said "now, close that notebook,

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that thing creates more problems than it solves." He said, "you'll never get any of those by." These unidentified spending cuts are well-identified.

The staff over on the Budget Committee put one out. We call it the Doomsday List. It has no chance of passing.

So it isn't just a nice pleasant volition of cutting more. They've got as many cuts as they could get. If they could get more, they would try for more. I may try to help them on that particular score.

But, they've gone as far like Kansas City as they can go on the spending cuts. Now they've got to hold back either on the increases in defense or on the tax cuts.

Senator BAUCUS. What I'm trying to drive at though, is the degree to which a large deficit, is in fact inflationary——

Senator HOLLINGS. Yes.

Senator BAUCUS [continuing]. Degree to which high deficit is harmful to the economy. Secretary Regan a few days ago was sitting right where you're sitting now said, "the old deficits per se aren't bad." And he's implying that we need a deficit for the reasons 1 earlier indicated. I'm just curious more precisely your view—you've already answered it.

Senator HOLLINGS. Yes.

Senator BAUCUS. What else, in your view, would argue that deficits are inflationary.

Senator HOLLINGS. It made me a believer. We've had large deficits and inflation and I certainly would like to stop them both. The large businesses can cope. They borrow at less than the prime rate. But, the small businesses, the individual, and the farmer, he is on the ropes in this country right now. And, he's not waiting for next March or April for his tax cut.

He's waiting for a signal from this Congress here in the next 60 days, that we've got sense enough to cut back on these interest rates by reducing the size of this tax cut, so we can aim the Government back around in the right direction away from deficit spending.

He's watching us in the next 60 days. He's not salivating over a big tax cut for next year, because he's not going to be around. He'll be out of business by that time.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Bradley.

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

Senator BAUCUS. I have no questions, I wanted to thank Senator Hollings, and we appreciate the flexibility we were given on the Senate Floor. But, there is a temptation to spend that $54 billion since the Budget Committee has directed us to do that.

But I do believe that you've indicated that's not one of the real problems, and that's the deficit. I'm sorry Senator Chafee is not here because he is very concerned about that as are other members of the committee.

It's our hope that we can reach some agreement with all the people that have an interest in tax legislation. That would at least accommodate some of the concerns you've expressed.

We are concerned about the marriage penalty. In particular, your statement indicated—that there is some question whether we have second tax package or we put it all in one.

We're going to try to restrain ourselves, but it's hard.

Thank you.

Senator HOLLINGS. Thank you very, very much.

The CHAIRMAN. If you're not taking pictures, just turn off the light.

Now, we can't see. [Laughter.]

That does help.

Our next witness is Lester C. Thurow, professor of economics and management, MIT.

Senator Bradley, do you want to introduce the witness, Lester's ready to go.

I'm pleased to have you here and I'm pleased that Senator Bradley made this suggestion.

Senator BRADLEY. I think that Professor Thurow's statement and answers to our questions will speak for themselves. We look forward to his testimony.

[The prepared statement of Lester C. Thurow follows:]

PREPARED STATEMENT OF LESTER C. THUROW, MIT, CAMBRIDGE, MASS.

10,10,10 PLUS 10,5,3 EQUALS?

In President Reagan's March 10th budget military spending is to rise by $181 billion, civilian spending is to rise $76 billion, and federal tax rates are to be cut 16 percent ($196 billion) between fiscal 1981 and 1986. If the President's budget is adopted just as recommended, total spending will rise by $257 billion or just about the same amount that it rose from 1975 to 1980 ($254 billion). But taxes are also to be substantially cut. They were not substantially cut in the earlier period.

If the 1975 period represents a substantial inflationary boost to the economy, then the 1981 to 1986 plans certainly represent an inflationary boost to the economy. In the President's budget, the federal deficit is eliminated by 1984 but this comes about only because of the projection of a supply side miracle. Real economic growth is to average 4.6 percent in 1982, 83, and 84.

The supply side miracle is highly unlikely if you examine the history of American productivity growth. The American economy cannot grow at 4.6 percent unless productivity growth exceeds 3 percent. But American productivity has been below that level for 16 years and has been negative for the last three years. What is going to cause a rapid turn-around in the productivity situation?

Higher productivity will require more investment in plant and equipment, a more highly skilled labor force, and major changes in American management practices. None of these things can come about quickly. Since it takes 5 to 10 years to build major new industrial facilities, new investment will not be contributing to productivity for a number of years.

Given that we have just one economy with which to play tiddle-winks, it does not make sense to count on the tiddle-wink coming down in the right spot. One can argue whether a supply side miracle will or will not occur, but to count on it in making economic policies for the nation is simply irresponsible.

This means it is necessary to modify the Reagan Administration's tax proposals. 10,10,10 has been supported as an incentive for savings and investment and as an offset for bracket creep and rising Social Security taxes. 10,10,10 isn't well designed to meet either purpose.

In 1980 the average American family saved 5.7 percent of their income. In the first 5 years of the 1960s there was essentially no inflation, rapid productivity growth, and great optimism. How much did the average American family save? Six percent of their income.

When thinking about that 6 percent savings rate three factors should be kept in mind. First it includes the savings of high income groups. The median family does not save 6 percent of its income. Second, it includes involuntary savings such as personal contributions to pension plans. Voluntary savings is much less than 6 percent. Third, it is not necessarily true that high income individuals will at the margin save more than middle income individuals. On average they certainly save

more, but they need not save more out of extra income. The high income family might use a tax cut to buy a second home since they have enough put away for their old age while a middle income family might save its tax cut because it is worried about how it will survive in its old age. Unfortunately we simply do not know what marginal as opposed to average savings rates look like as you go up the income scale.

10,10,10 will increase savings, but only by about $6 out of every $100 in tax cuts. That will simply not give us the extra savings that we need to restore productivity growth or to compete with our international competitors.

Because of the baby boom we would have to raise investment from 11 to between 13 and 14 percent of the GNP just to hold the amount of capital per worker constant. To keep up with 20 percent Japanese savers and 14 percent German savers in terms of capital per worker we would have to invest much more. The Japanese invest 20 percent of their GNP in plant and equipment, but they do not have our baby boom to equip. If we were to invest as much per worker as they are now investment (and we won't compete unless we do), we would need to invest 30 percent of our GNP in plant and equipment.

Thus we need a personal tax cut that is not 6 percent effective with it comes to stimulating savings, but 100 percent effective.

It is possible to achieve 100 percent efficiency. Suppose that you were to adopt a tax reform that resulted in unlimited Keogh accounts open to everyone. Americans could save tax free, but if whenever they withdrew money from their savings they would have to pay taxes upon it. The Japanese have such a system with a limit of $15,000 per family per year that can be saved tax free.

With this personal tax reduction, no tax revenue would be lost unless Americans were willing to save.

With this personal tax reduction, every dollar in lost revenue would result in more than one dollar of savings. At the 50 percent marginal bracket an individual would have to be willing to save $2 to get a $1 tax cut. The savings efficiency of the tax cut would be more than 100 percent.

Viewed as an offset to bracket creep and Social Security tax increases, 10, 10, 10 is equally inefficient. It simply does not deliver the tax cuts to those that will be facing tax increases from these two factors. Both bracket creep and Social Security tax increases will most severely affect middle income groups, but 10, 10, 10 delivers most of its tax cuts to upper income groups.

If these two problems are to be corrected, the efficient solution would index the tax system and deliver income tax cuts to precisely those income groups that are experiencing the Social Security tax increases. Neither is difficult to do technically.

10, 5, 3 is supposed to stimulate industrial investment. But it is equally poorly targeted. The greatest incentives are given where there is the greatest difference between tax lives and actual economic lives. When examined from this perspective the greatest incentives are being given for buildings. Buildings last far more than 10 years and can also be sold and depreciated many times.

As a result 10, 5, 3 will be a tremendous incentive to invest in office buildings and shopping centers. But we do not need more office buildings and shopping centers, we need industrial factories full of equipment.

Many types of equipment do not last 3 years and it is not in general possible to sell and re-depreciate industrial equipment. As a result we will be discouraging investment in some of our industries, such as electronics, that we want to encourage. In conjunction with the tremendous incentive for speculative building that 10, 5, 3 provides we may very well end up sucking investment funds out of industry and having less investment in industrial facilities after 10, 5, 3 is adopted than before it was adopted.

Here again it simply is not necesary to accept a distorting inefficient tax cut. The Reagan administration's objectives can be reached more efficiently in a number of ways. A simple cut in the corporate income tax rate is one. The Jorgenson-Auerbach net present value depreciation proposal is another. Either would be far better than 10, 5, 3 and could be adjusted to cost the same amount of revenue lost.

When it comes to tax cuts there is no quarrel about objectives. America desperately needs more savings and investment. But let us design a set of tax cuts that will bring us to those objectives. This should be an area where it is possible to have a bipartisan policies.

STATEMENT OF DR. LESTER C. THUROW, PROFESSOR OF ECONOMICS AND MANAGEMENT AT THE MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. THUROW. In President Reagan's March 10 budget, military spending is to rise by $181 billion and civilian spending is to rise by $76 billion.

If the President's budget is adopted, just as recommended, including the as yet unspecified budget cuts, total spending will rise by $257 billion or just about the same amount that it rose from 1975 to 1980—$254 billion.

But, income taxes are also to be substantially cut. Income taxes were not substantially cut in the earlier period.

The CHAIRMAN. Could I interrupt just briefly there to confirm that you are presenting only a summary. I understand your complete statement is 19 pages. I was getting a little nervous.

Dr. THUROW. No, no. Four pages.

The CHAIRMAN. We have 17 witnesses this morning.

Dr. THUROW. If the 1975 to 1980 period represents a substantial inflationary boost to the economy then the 1981 to 1986 plan certainly represents an inflationary boost to the economy.

In the President's budget the Federal deficit is eliminated by 1984, but this comes about only because of the projection of a supply side miracle.

Real economic growth is to average 4.6 percent in 1982, 1983, and 1984. This supply side miracle is highly unlikely if you examine the history of American productivity growth. The American economy can not grow at 4.6 percent unless productivity growth exceeds 3 percent.

But, American productivity has been below that level for 16 years, and has been negative for the last 3 years.

What is going to cause a rapid turnaround in the productivity situation? Higher productivity will require more investment and plant equipment, a more highly skilled labor force and major changes in American management practices.

None of these things can come about quickly.

Since it takes between 5 and 10 years to build major new industrial facilities, new investment will not be contributing to productivity for a number of years.

Given that we have just one economy with which to play tiddlywinks, it does not make sense to count on the tiddlywink coming down on the right spot.

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When thinking about the 6-percent savings rates, three factors should be kept in mind.

First, it includes the savings of high income groups, the medium family does not save 6 percent of its income.

Second, it includes involuntary savings such as personal contributions to pension plans. Voluntary savings is much less than 6 percent.

Third, it is not necessarily true that high-income individuals will, at the margin, save more than middle-income individuals. On average they certainly save more, but they need not save more out of extra income.

The high-income family might use a tax cut to buy a second home, since they have enough money put away for their old age, while a middle-income family might save its tax cut, because it is worried about how it will survive in its age.

Unfortunately, we simply do not know what marginal as opposed to average savings rate look like as you go up the income scale. The 10-10-10 will increase savings, but only about $6 out of every $100 in tax cuts.

That simply does not give us the extra savings that we need to restore productivity growth or compete with our international competitors.

Because of the baby boom we would have to raise investment from 11 to between 13 and 14 percent of the GNP, just to hold the amount of capital per worker constant. To keep up with the 20-percent Japanese savers and investors and the 14-percent German savers in terms of capital per worker, we would have to invest much more.

The Japanese invest 20 percent of their GNP and plant equipment, but they do not have our baby boom to equip.

If we were to invest as much per worker as they are now investing and we won't compete unless we do, we would need to invest 30 percent of our GNP and plant equipment.

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It is possible to achieve more than 100 percent efficiency.

Suppose that you were to adopt a tax reform that resulted in unlimited IRA and Keogh accounts open to everyone. Americans could save tax free, but if they withdrew the money from their savings, they would have to pay taxes upon it.

The Japanese have such a system with a limit of $15,000 per family that can be saved tax free. With this personal tax reduction no tax revenue would be lost unless Americans were willing to save. With this personal tax reduction every dollar in lost revenue would result in more than $1 of savings.

At the 50-percent marginal bracket, an individual would have to be willing to save $2 to get a $1 tax cut. The savings efficiency of the tax cut would be more than 100 percent.

Viewed as an offset to bracket creep and social security tax increases, 10-10-10 is equally inefficient. It simply does not deliver the tax cut to those that will be facing tax increases from these two factors. Both bracket creep and social security tax increases will most severely affect middle-income groups. But, 10-10-10 delivers most of its tax cuts to upper-income groups.

If these two problems are to be corrected, the efficient solution would index the taxes and delivery income tax cuts to precisely those income groups that are experiencing the social security tax increases. Neither is difficult to do technically.

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The greatest incentives are given where there is the greatest difference between tax lives and actual economic lives.

When examined from this perspective the greatest incentives are given for buildings. Buildings last far more than 10 years and can be sold and depreciated many times.

As a result 10-5-3 will be a tremendous incentive to invest in office buildings and shopping centers, but we do not need more office buildings and shopping centers, we need industrial factories full of equipment.

Thank you.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Doctor, all of us were using the term "savings." What does that mean? What do we mean by savings.

Dr. THUROW. Basically, you mean not consuming. It's resources that the American public is not consuming and therefore they are available to be put into productive investment.

Senator PACKWOOD. Does it include investment in stocks. Or is that not a savings?

Dr. THUROW. That is not savings from an economic point of view. It includes the purchases of real plant and equipment. If you invest in stocks new issues and the new issue money is used to buy new equipment then that is the investment in the economic sense. If I buy a stock from somebody who already owns a share of stock that's not investment.

Senator PACKWOOD. Does it include a portion of the wage earner's check that is put into social security? Is that savings?

Dr. THUROW. That is not savings for the individual.

Senator PACKWOOD. Why?

Dr. THUROW. Because the Federal Government takes the money and then pays it back out——

Senator PACKWOOD. Spends it immediately.

Dr. THUROW [continuing]. To older individuals. So, it's a transfer from one individual to another, but not net savings for the society as a whole.

Senator PACKWOOD. You had an article in the New York Times magazine section 2 or 3 weeks ago, where you talked about favoring a progressive consumption tax. Do I take that to be evaluated to mean a tax exempting food.

Dr. THUROW. No, if you move to a simple system of unlimited Keogh's and IRA's you would then convert the income tax automatically into a progressive consumption tax.

Senator PACKWOOD. I didn't follow that. I heard what you said, but slow down a bit.

Dr. THUROW. Suppose you made a $100,000 and you saved $10,000 and spent $90,000. Well you would then pay taxes on $90,000 worth of consumption. On the other hand, if you earned $100,000, withdrew $10,000 from your tax free accounts, dissaved $10,000, then you would pay taxes on $110,000. And so you pay taxes on the

amount that you consume at your progressive income tax rates, but you don't pay taxes on savings.

Senator PACKWOOD. So you move toward the consumption totally by going through the one form of another of the income tax.

Dr. THUROW. Right, if you simply have unlimited Keogh's and unlimited IRA's you instantly converted the Federal income tax into a progressive Federal consumption tax.

Senator PACKWOOD. And, therefore, need no value added tax——

Dr. THUROW. Need no value added tax in that situation.

Senator PACKWOOD. You made reference to the savings rate in 1980 at 5.7 percent in the first 5 years. I actually have 6.3 percent for those 5 years. That's not the point. Why is it we have the highest savings rate—of a 5-year average was 1971 through 1975 and at 3 years 8.6, 8.5, 8.6 in 1973, 1974, and 1975, the highest in our history, except, World War II, and yet our investment and productivity was falling at that time.

Dr. THUROW. Well, I think there are two answers. If you ask why did we have the high savings rate, it used to be that when Americans thought they were facing economic disaster they raised their savings rate, so when unemployment went up, savings went up. When people got fearful about their economic future, savings went up.

But, one of the things the American public has learned with inflation is that is stupid behavior and now when you see disaster coming down the road, you lower your savings rate. I think that's one of the fundamental places where American behavior has changed. When we see disastér down the road, we now save less, where 10 years ago it caused us to save more.

Now, again, if you think about why did productivity fall when savings was high, the big reason for that on the investment side is the baby boom, because we've actually invested more. If you look at the period from 1945 and 1965 when productivity was 3 percent, we were investing 9½ percent of the GNP and in the last 3 years while productivity was falling we invested 11.3.

The difference is the baby boom. We have got millions of workers to be equipped, each one of those workers takes $50,000 worth of plant equipment on average, and as I mentioned in my testimony, we would have to bring American investment up to 13 or 14 percent of the GNP just to keep even with the baby boom. That wouldn't give us any increase in equipment per worker, it would just hold even.

Senator PACKWOOD. Separating savings from investment, I am struck by our historical comparative low savings rate even when we had periods of great boom and great expansion. We are not historically a country of great savers, and I think, as I indicated earlier, we have not needed to be, because we did not finance our expansion principally through savings.

If we could look forward to a growing economy, and a stable interest rate, relatively low inflation rate, do you think we would return to the normal rate of savings we've had in the past which is used to finance housing and in some degree small business without any so-called targeted tax savings.

Dr. THUROW. I don't think we could for two reasons. First of all, we've got this very difficult problem of digesting the baby boom

that will require a major increase in savings to equip them. The second thing is we've now got international competitors in a way in which we never had for the last 30 years.

There are countries out there that are now technological equals, that are saving a lot more than we're saving and therefore, the good old days aren't good enough. Not because the good old days weren't good, but in the good old days we didn't have technological competitors like the Japanese that were our equal saving 20 percent.

Senator PACKWOOD. Yes, but wait. Again, it is an historical act that Japan finances most of its expansion through savings. I was on the plane with Secretary Baldridge the other day and he had just returned from the Far East. He said, off the top of his head, he would bet that Japan finances 80 to 90 percent of their expansion through savings or bonds. They have to have a high savings rate.

Dr. THUROW. Well, we see we all finance through savings. The question is whether we do it through personal savings or corporate savings.

Senator PACKWOOD. That's why I asked you whether you counted as savings the purchase of stock and you said no, that is not a savings.

Dr. THUROW. But, if a corporation retains earnings and invested in plant and equipment, that is savings, and historically, American corporations have done more savings than their European or Japanese equivalents. Now the problem is if you look at their total income and then match it with what we need to do, even if they were paying out no dividends and saving all of their income, it just doesn't meet the requirements.

I think we definitely need a major increase in savings for the two reasons I mentioned—the baby boom and international competition which is a new fact of life in America, because after World War II for 20, 30 years we were without any technological equals. That isn't the world we're in anymore.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. It's just a fact of life that we have to do business this way sometimes, but you had to read your statement very rapidly, and I lost quite a bit of it. But I really don't think it's long enough to do justice to your views anyway.

I would like to invite you to expand on the 20 pages you've got here. Those who might be inclined to agree with you would find it interesting to read, and those who are interested will have an opportunity to read it—not in this morning's session, but you've got some very thoughtful points here, and I really think in justice to you and to the committee it would be well if you expanded on what you have and give us a longer paper that we can study.

You know when you have to present something in 5 or 10 minutes, quite a bit gets lost either in the abbreviation or in the rapid machinegun fashion you have to use when you read the words. What your're trying to tell us here I think deserves thoughtful consideration.

Dr. THUROW. I'll be glad to give you that paper.

Senator Packwood (acting chairman) presiding.

Senator Byrd.

Senator BYRD. No questions, Mr. Chairman.

Senator PACKWOOD. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Professor Thurow, I share Senator Long's point that its quick and I had a hard time following all the intricacies and points—I would very much like to see it expanded too.

One question I have though, is your reaction to the assertions by various people that Americans will save 50 to 60 percent of the tax revenue they would receive through a 10-10-10 tax cut. What's your reaction to those?

Dr. THUROW. My reaction to that is there is no historical evidence that they have ever done that in the past, and I can think of no reason why they should do that in the future given an unlimited tax cut. That just isn't American behavior. Now, it would be nice if it were American behavior, and I've debated a number of the Reagan economists recently, and when you come down on that issue, sooner or later they get to the point. They say you have got to have faith.

Well, I suspect the problem is that I don't have the faith. [Laughter.]

And, I don't think there's any history that going to give you the faith.

Senator BAUCUS. These assertions I think are based primarily on polls, and maybe Americans like to think they like to save. It's hard to tell.

More precisely, what is it in history that strongly indicates Americans won't save that much or what by the present conditions should make it likely or unlikely.

Dr. THUROW. Well, I think it's what Mr. Packwood mentioned recently, and that is the American savings' rates have never been high throughout our history. We're just in this unfortunate period where we really do need a lot of savings, and that kind of requires a wrench to the system to force us to do different things than we've done in the past.

Now, if you look at why people around the world save more than we do. It isn't because they like to save. It's because they are put into an environment where they have no choice. As was mentioned consumer interest isn't deductible anywhere else in the world. Lots of countries like Germany mortgage interest is not deductible. Many countries in the world you have to have big downpayments to buy anything, or even cash for a car. You can't buy it on credit.

All those things stimulate savings in the rest of the world and they save because they have no choice, not because they like to save.

The other day I was in Los Angeles, and I flipped on the TV and there was a TV ad that was advertising that you could buy a $30,000 recreational vehicle with no downpayment. Now if you can buy what you want with no down payment, then there is no reason why anybody in the world should save regardless of whether the tax rates are 100 percent or zero. It doesn't make sense to save in a world where you can get anything you want without saving.

Senatur BAUCUS. That's true. I talked to a fellow the other day who tried to buy a second home. When he finally figured out that

he could buy the home he couldn't swing the down payment. The down payment was low, like 18 percent, so he decided to borrow the down payment.

Well, what about the taxes, how are you going to pay the taxes? Borrow it. What about the interest? Borrow it. The result: Everybody's borrowing for everything these days.

Dr. THUROW. We have a crazy system where you tax interest and allow tax deductibility of consumer interest. You tax the interest you earn and you don't tax the interest you pay. Most other countries have it exactly the opposite.

Senator BAUCUS. Thank you.

Senator PACKWOOD. Senator Bradley.

Senator BRADLEY. Yes. Thank you, Mr. Chairman. As I understand what you've said today, to get economic growth, and to get increased productivity you have to have increased investment and you can't have increased investment unless you have increased savings. And one of the things that I think that the Committee has agreed upon is that we have to have increased savings.

The question really is, How can we assure that we're going to have new savings, not simply shifting savings from one institution to another institution. And, one of the unanswered questions that I think Senator Baucus touched on is how can we be sure that there will be a net increase in savings. In your statement you said that the marginal rate of savings is not necessarily higher for upper income people than for lower or middle-income people. Could you expand on that somewhat? What does that mean, therefore, to those of us who are trying to structure a tax measure that encourages savings?

Dr. THUROW. Well, the basic problem is that nobody knows what the marginal savings rates are. We know what average savings rates are, but nobody can be sure that a high-income individual will save more than a middle-income individual.

And in the example I gave, I had an example where a middle-income individual would save more. Now, that basically means, I think, that you don't want to leave it to chance. If you want savings, you don't give people some income and say do with it what you wish, because given American history we know they will wish to consume about 94 percent of it. You give people income in such a way that you really get the savings you want.

Now, as I mentioned, I think that by far the preferable way to do it, is to move toward making IRAs and Keogh's unlimited and open to everybody and that is a tax cut that if Americans choose not to save you won't lose a dime's worth of revenue. Because they've got to save before you start losing money in that kind of an operation, and it seems to me that's the kind of efficiency you want, if you're really serious about raising savings.

As I said I just don't have the faith when it comes to Americans even saving 40 to 50 percent of 10-10-10.

Senator BRADLEY. So, you're basically arguing for what you call the progressive consumption tax.

Dr. THUROW. Right.

Senator BRADLEY. What if we had unlimited IRA's and Keoghs? Should we expect that if we had unlimited IRA's and Keogh's that suddenly the American saver would turn from a six percent to

a 14 percent saver, and if not are there other things required beyond various tax incentives in order to make sure that Americans increase their savings.

Dr. THUROW. I don't think tax incentives would get us there for some of the reasons I mentioned to Senator Baucus that the rest of the world also gets there with a set of sticks as well as a set of carrots. Some of the sticks are bigger down payments, some of the sticks are you can't deduct consumer and mortgage interest. There are a whole variety of sticks.

Most of Europe has a big value-added tax which is a tax on consumption. It's up to 25 percent in Sweden, if you insist on buying a $1,000 motorcycle you send $250 to the government and if you don't buy the motorcycle you don't send it. Well, that's a powerful message that says don't buy the motorcycle.

And, you can go through a whole series of things. For example, the Japanese pay workers with about a third of their income and a bonus, what do you think would happen to your savings rate if I marched into your life, took a third of your income away from you, and then gave it back to you as a bonus every 6 months. Well, I know you'll save it for 6 months, because I won't give it to you. And the chances are, if you have a low monthly income and then have to get through—have a bonus you'll save it for part of the next 6 months, so you don't starve to death.

Well, all of those things are what forced those high savings rates, and so I think if you were really serious about turning Americans into big savers, Congress would have to think about some sticks as well as some carrots. Carrots will get you part of the way, but it won't get you all of the way.

Senator BRADLEY. If you don't have—if you can't assure yourself a lot of new savings on the one hand and yet on the other hand you give real incentives for increased investment, what does that mean for interest rates.

Dr. THUROW. It basically means higher interest rates.

Senator BRADLEY. Why?

Dr. THUROW. Well, because you've got a tremendous increase in the demand for investment funds and you haven't done anything on the other side of the market to stimulate the supply of investment funds, and if we're now all big believers in supply side economics, that presumably means we're big believers in increasing the supply of savings in the economy, and in investment tax cuts without something done dramatic to increase the savings only makes the problem worse when it comes to interest rates.

Senator BRADLEY. So, it raises the interest rates.

Dr. THUROW. It raises interest rates.

Senator BRADLEY. That will certainly have an inflationary impact as well.

Dr. THUROW. It raises real interest rates I should say, not just nominal interest rates and in that situation you get an increase in the real interest rates.

Senator BRADLEY. We will hear later today from a number of witnesses who will testify to the increased depreciation plan that's before us; the so-called 10-5-3. My question to you is, Do you think that if what we really want is to get increased investment in plant and equipment would we be better off with an accelerated depreci-

ation allowance or would a corporate tax rate cut across the board be better. And when we're talking about increasing investment, we're talking not just about increased investment in plant and equipment, we're also talking about increased investment in people, increasing skilled labor.

My question to you is would you prefer a corporate rate cut to the depreciation allowances, and second, what can we do to increase the supply of skilled workers in this country.

Dr. THUROW. Well, I think that if you look at the problem as more than a lack of equipment, it's also a lack of those skilled blue-collar workers. That argues for a rate reduction as opposed to depreciation allowances. If I had a given amount of money to hand out to corporations, I would hand it out in the form of an across-the-board rate cut as it is opposed to depreciations.

Especially, when you realize that 10-5-3 by the time you get to the late 1980's will have essentially abolished the corporate income tax anyway.

Senator BRADLEY. Well, could you——

Dr. THUROW. Why not abolish it and get rid of your tax lawyers and your tax accountants.

Senator BRADLEY. Could you go into that a little bit more. What do you mean 10-5-3 by the 1980's——

Senator PACKWOOD. Bill, your time's up. Why don't you ask that question again in the second round.

Senator BRADLEY. Could he just answer that question.

Senator PACKWOOD. Go ahead and answer that question.

Dr. THUROW. Basically, it will mean the depreciation allowances are so large that very few corporations are going to have taxable income left by the time you get to the late 1980's.

Senator PACKWOOD. Senator Bentsen.

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

Dr. Thurow, I always find your testimony interesting. I've listened to you many times. I share with Senator Long the desire that you give us this in more detail. I'll look forward to studying it.

The term "supply-side economics" has been corrupted, so I'm not sure what it means any more. I think it's been taken far beyond the original intent and some of the things some one thought helped.

I look at the problem of 10-5-3 and I was one of the original cosponsors of 10-5-3. But, I think we've found some of its problems as we studied it.

In the Finance Committee we came up with 2-4-7-10 which dealt with more neutrality on assets, but as we've looked at that we've found we could improve it too. And, hopefully, whatever we come up with will have more neutrality and will not result in negative cost basis and equipment, which I think is going much too far.

But, as I listen to the talk about top bracket saving, I really don't think they're going to save much, because they are the most sophisticated of the investors, and I don't think they're going into straight savings accounts, unless there's some kind of an incentive there.

I'm very much interested in what you're saying about the Japanese. As I understand what you're saying they put a limit of

$15,000 maximum that you take off the top of your income, not to clear that subject to tax, put it in a savings account, and not include the tax until you withdraw it. Isn't that the way it works.

Dr. THUROW. Right.

Senator BENTSEN. Now one of the studies I saw said they could get up to $63,000 equivalent to the yens, by such structured-type savings in Japan.

Another shows that the English and the French virtually do not tax interest received, but there are some exceptions, and that the Germans even go so far as to subsidize to the consumer.

But I get concerned about the political problem that you're talking about, if you approach from the way you say. If we cut the top-end income tax from 70 to 50, frankly I support it, because I think you see an awful lot of those people going into some kind of tax shelter. And, if they end up at 70 percent, they end up only because of very poor planning and being surprised by it.

But, if you do that, and you give the fellow at 50 percent $2 for $1 and the fellow at 30 percent something less. Now we have all kinds of political problems in accomplishing that.

Dr. THUROW. One of the things you can obviously do, if you want to, is like all deductions can be converted to credits where you can give a credit of so many cents on the dollar saved which is then equitable across the different income classes. That's another way to do it and it certainly is generally true that if you're worried about the equity issues the tax credits are a better way to go than tax deductions.

Now, let's say you wanted to offer a 30-percent credit for every dollar saved that was open to everybody from rich to poor. Well, that's equitable in the sense that you're giving the same incentive to everybody to save.

Senator BENTSEN. Now, the other point where you talked about every dollar in lost revenue resulted in more than $1 of savings, and of course, that's right depending on the tax bracket.

Wouldn't you anticipate—have you had any kind of an econometric model run—wouldn't you anticipate that in the first year of this that you'd have a rate inflow of savings, and that you'd have a substantial addition to the deficit.

Dr. THUROW. I don't think so, because if you look at the current 6 percent American savings, and that's what you're saying people are already saving 6 and how much money are we going to give away to get them to save that 6. A lot of that 6 percent goes into things like pension plans and things——

Senator BENTSEN. I know.

Dr. THUROW [continuing]. Like that, that aren't under the control of individuals.

Senator BENTSEN. I understand, but I would think that what you're proposing, and I'm deeply concerned about the savings rate in this country and I totally agree that we have to turn that around or we are not going to have the capital to do the rebuilding of America that we're talking about. Housing or what have you.

Dr. THUROW. But, see if you're worried about the revenue laws, it seems to me you can phase it in, because if you take the $15,000 Japanese limit, you can have, you know, a $5,000 limit the first year, $10,000 the second, $15,000 the third. Whatever you think are

the right set of limits that lose you the amount of revenue that you want to lose.

And, so I think the question of how much revenue you lose can be essentially solved by capping the maximum amount that you can put.

Now, let me also emphasize, if you think of IRA's and Keoghs, it's not just bank accounts. Your Keogh account could be with Merrill Lynch and invested in equities and lots of other things other than savings banks.

Senator BENTSEN. All right, I have not run the mathematics on this one, but what would be the difference in the loss of revenue if you took something like that proposed a couple of years ago, they cut me down from the $2,000, $1,000 to $400 and $200, which didn't have any real effect, again not significant. Now not paying a tax on that interest earned and doing what you're talking about, not paying a tax on the amount of money earned, to the extent it's put in a savings account.

I recall that my first one brought about a $7 billion deficit according to the figures of the Joint Tax Committee. If it had been at $2,000 and $1,000, would there be a substantial variance if you took your approach.

Dr. THUROW. I don't think there would be a substantial variance, but I think there would be a bigger benefit to my approach as opposed to that approach because under the Keogh approach, you have big incentive to——

Senator BENTSEN. I think you may be right on that.

Dr. THUROW. Because if you take it out you get penalized. Under your approach, once you've got the $1,000 worth of interest tax free, then you might as spend the $1,000 worth of interest.

Senator PACKWOOD. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Let me ask you about the expansion of the IRA's and the Keoghs. We have some legislation in that would provide that the expanded IRA's could be used for not only retirement, but also for college education expenses and first purchase of a home. What do you think of that as an incentive for the younger people to get into the program?

Dr. THUROW. I would take off all the limits on what the money could be used for. You simply say, as long as you leave the money there, you don't pay the tax. You take it out for any reason you pay the tax. And so, it would cease to be a bill—program designed to encourage people to save money for their old age. It would be a bill designed to encourage people to save, period.

Senator CHAFEE. And, they could take out any amount.

Dr. THUROW. If they wanted to pay the tax. But, the minute they take any money out, they pay the tax.

Senator CHAFEE. That's right. They pay the tax in the year they take it out.

Dr. THUROW. The year they take it out. So you've got an incentive to put money in and leave it there, and I see I think the problem about having good things to spend it on is the problem; there's a lot of other good things to spend it on.

One of the things we clearly want is productive investment and industrial plant equipment. And, for example, one of the problems

with housing in the United States at the moment is in some sense—say, if you take second homes, we've got too many houses. America cannot afford a lot of second homes at the moment. And so I would be very reluctant to see any savings incentive that focused money in on housing, because a lot of that money is de facto going to go into second homes as opposed to first homes.

Senator CHAFEE. That would have to be for the first home purchased by the saver with a limitation of $10,000. Let me discuss a minute with you the 10-5-3 objections to it.

What do you think if we didn't have the 10, that is as as far as real property goes, we stretch that out, make it maybe 15 years full market price, and something longer. But, try to concentrate in the machinery and equipment.

Dr. THUROW. I think it's the machinery and equipment that is key. If you want neutrality, what you do is go on off and try to measure economic lives and then let's say tax lives are going to be half of economic lives or whatever the number is, but the big problem is that this has got tremendous distortions, because the 3 is longer than that on which much equipment is depreciated now, say, and electronics around Boston, the 10 is grossly less than how long a big office building lasts, and so you get an incentive to take your money out of 128 electronics firms, and put it into downtown Boston office buildings.

Well, I don't think that's the incentive Congress wants to deliver to American industry.

Senator CHAFEE. Well, what do you say if we—say your thought is that we should stretch out the real property depreciation. Suppose it's a legitimate factory here, owner-occupied plant. Do you see incentive there——

Dr. THUROW. Well, if you think of it in industrial properties, typically the factory building is a small part of the total cost. The equipment in the building is going to cost a lot more money than the building, and so when you start giving incentives for the building, you're really giving incentives for shopping centers and office buildings because building is not a big part of industrial plant equipment.

Senator CHAFEE. OK, so what would you do. Would you say for industrial facilities it would be what?

Dr. THUROW. Well, let's say you want to go to half lives, and you've got buildings that last 70 years and equipment that lasts 3. Well, then the building life should be 35 and the equipment 1½. For example, you should be cutting them all proportionately, if that's the game you're trying to play.

Now, I think that's very difficult technically to do, because we've got many types of equipment. As I said, I would prefer to go to a straight across-the-board corporate income tax cut. If you've got a certain amount——

Senator CHAFEE. Well, forget the whole 10-5-3.

Dr. THUROW. Forget 10-5-3 and lower the corporate tax rate.

Senator CHAFEE. To what?

Dr. THUROW. Whatever amount of money you've got to hand out.

Senator CHAFEE. Well, now, there's an awful lot of businesses in the United States that are not incorporated, that are sole propri-

etorship, partnership, what are you going to do about them? What do they get out of this?

Dr. THUROW. Well, if you're talking about——

Senator CHAFEE. Corporate rate doesn't help them, cutting the corporate rate doesn't help them. You say you're opposed to the 10-10-10 individual cuts——

Dr. THUROW. Sir, if you want to do that for unincorporated business, then you could have depreciation allowances for unincorporated business, but the corporate part should be handed out as a rate cut.

Now, see the problem with doing depreciation allowances is that you're also biasing the choice toward equipment and away from people.

If you look at American productivity, there's just as much problem of having a lack of skilled blue-collar workers. I mean, who is going to prepare these machines if you don't have any machinists. Who is going to build these machines if you don't have any tool and die makers?

You've got a set of incentives here that are all equipment loaded and nothing for the human beings who are going to run and build this equipment.

If you got the corporate tax rate, then you have something that encourages the production of these skilled people as well as the production of this equipment, and we all know the problem in American military where you've got a lot of equipment you can't run.

Having a lot of equipment you can't run in the American industry also doesn't do you any good.

Senator CHAFEE. All right, fine. I must say you're setting forth a new path here for us. I'm glad you're here.

Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Thurow, I wasn't here when you read your statement, but I have since read it and I find it interesting. Last week we had witnesses, the Secretary of the Treasury and other administration witnesses and some economists who supported that position—took the position that the best thing we can do to encourage savings is to adopt Kemp-Roth, and forget about any savings incentive.

I gather reading your statement and listening to you here, you disagree with that strongly.

Dr. THUROW. I simply disagree with it because when you go back through American economic history, you can't find any period of time when Americans saved the kind of money that Secretary Regan says their going to save, and the world hasn't changed. You can still buy my recreational vehicle without a down payment, and I just do not believe they are going to save much more than 6 percent of their income, tax reduction.

Senator MITCHELL. So, I understand your view then that if we're going to encourage savings which seems to be now to have reached the level of the American flag and apple pie, that we have to devise some specific savings incentives.

Dr. THUROW. I think that's right.

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Senator MITCHELL. And, you have suggested one in your testimony here, the so-called unlimited Keogh account.

Interestingly enough, there's part of the administration's proposal the interest in dividend exclusion is to be terminated. That is a specific savings incentive that was designed for the purpose of encouraging savings. The administration now proposes not to extend that—the Secretary said, in response to my questions,"Well, that's not a bad idea and we'll think about it at some later time." Do you have an opinion on that as a savings incentive?

Dr. THUROW. Obviously, it's a little bit adverse. I think that if you're really interested in savings, one of the things that we were talking about earlier is corporate savings. You might want to adopt tax legislation to discourage the paying of dividends and force corporations to save more. That's also a direction in which you could move.

Now, another direction you can move to increase savings and just not have 10-10-10. The Federal Government has that much more revenue, you have that much of a smaller deficit and savings is up by that amount. So simply not having 10-10-10 is, in fact, a savings device.

Senator MITCHELL. Well, what about—I'd like your comment on this specific incentive of the interest exclusion.

Dr. THUROW. I think most of the evidence indicates that the interest exclusion has never been a tremendous incentive for people to invest in equities, plus the fact that most people who invest in equities lose it in the issues your investing in.

In terms of savings and investment, the only kind of an equity that counts is a new issue. Now, it's a little bit of an incentive to issue new equities and have people buy them, but I don't think it's a terribly efficient way to go if you want to get a lot of savings.

Senator MITCHELL. Thank you, Mr. Chairman. I have no further questions.

The CHAIRMAN. We still have two. I hope they are not going to ask any questions. Senators Danforth and Wallop. [Laughter.]

Senator BRADLEY. You mean, Mr. Chairman, before we go into the second——

The CHAIRMAN. Well, we have a lot of witnesses who would like to be heard this morning, so I hope we can proceed——

Jack, do you have a question.

Senator DANFORTH. No questions. [Laughter.]

In Senator Long's earlier statement, I think we have an outstanding witness, which some of us would like to spend some time with, but I'm not certain if you can do it all this morning. But I'll forego my questions, and hope that anybody who has a second round of questions will forego theirs.

Senator BRADLEY. Mr. Chairman, I don't want to take the committee's time. I would like to ask one more question but are you saying that we are going to invite Dr. Thurow back to testify before the committee again.

The CHAIRMAN. Certainly, I think if we're going to have more witnesses we could invite him back to celebrate the passage of 10-10-10. [Laughter.]

Senator BRADLEY. Mr. Chairman. I suppose that's the first public comment by you that you are in full support——

And, I think we could cross-examine you.

Let me just ask just one last question. I appreciate your willingness to have Dr. Thurow, and I concur that the committee could benefit from a longer period with him. Let me just ask a question about the growth rate assumptions on the budget and the tax plan.

First of all, if we take the projected growth rate compared to historical growth rates in the country, and assess the probability of achieving the projected growth rate, what are the repercussions on inflation rates, interest rates, unemployment rates, and the deficit if that growth rate is not achieved.

Dr. THUROW. If you look at the President's projections obviously the growth rate is the key thing, because as I said its real rate of growth averages 4.6 percent per year in 1982, 1983, and 1984.

Now, that is only possible in the American economy given how fast population is growing as if you have productivity growing it's something more than 3 percent a year.

Now, as I mentioned productivity hasn't been at that level for 60 years. It's been negative for the last three. And, why it's going to jump up to plus three in 1982 is simply beyond—and I see no explanation in the administration's proposals as to why we should believe in plus three in 1982.

Because if you think of everything you know about productivity it is very difficult to turn it around. It is time consuming to turn it around. New factories have to be built, new people have to be trained. It is just not the kind of thing that instantly pops around when you change the tax law.

Now, changing the tax law may help on productivity in the long run, but it's not going to give you that kind of instant response that's in the President's projections in March.

Senator BRADLEY. If you don't get the growth—what happens to inflation and interest rates, unemployment and the deficit.

Dr. THUROW. You simply get a bigger deficit and then a big increase in defense spending becomes a real inflationary pressure if you don't have a big growing economy to essentially absorb it.

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

Senator LONG. Mr. Chairman. I have yet to ask a question.

The CHAIRMAN. Oh, excuse me.

Senator LONG. Could I ask just one quick question?

The CHAIRMAN. Sure.

Senator LONG. In view of your challenging statement, I have sent a few of our staff people from the room to consult the scriptures for further guidance, and here's what the Bible says:

> If you have faith as a grain of mustard seed, you will say unto this mountain, do ye remove to another place. It will move and nothing will be impossible.

Now it doesn't say a thing there that it will move only if these infidels will cooperate, just that it will move. [Laughter.]

So if you're going to do it on faith, you don't need the tax cut. If your faith is strong enough, it will just move. [Laughter.]

I do find myself a little concerned about your statement that you might as well just repeal the income tax, because it seems to me that if you have an income tax there, you won't get the relief from the income tax unless you make the investment. That being the case, I don't understand your argument when you suggest that you just ought to repeal the income tax rather than to have the tax

and give people the credit if they do make the investment. Now what's your reaction? It seems to me that you're making exactly the same argument about the Keogh plan and things of that sort that if they make the investment, they get the tax savings.

A corporation pays a 46 percent income tax, but if they buy that machinery, they get depreciation and the investment tax credit.

It seems to me as though you are flying right in the face of your own logic.

Dr. THUROW. But, see, we're asking, "what are we going to have to do to get more investment? If they just invest the amount that they're now investing under 10-5-3 you're going to be collecting very little corporate income tax revenue by late 1980. And you're really asking what will get investment up and it just doesn't seem to me that 10-5-3 is the kind of vehicle that's going to get investment up, and you want to get other types of investment up, the human investments that I talked about.

Now, all of the economics requires a bit of faith. The corporations are going to be intelligently managed and when we lower their tax rates they're going to respond to those in a reasonably efficient way. But, I think we know there we have some historical evidence that they will invest in the right way. When it comes to the personal tax cut we have all the historical evidence that they won't save more.

Senator LONG. Thank you very much.

The CHAIRMAN. Thank you, Dr. Thurow.

Our first panel—Charls Walker, chairman, American Council for Capital Formation, Cliff Massa, vice president, Taxation and Fiscal Policy Department. If you could summarize your statements we would have some time for questions. We'll start in the way you're listed. Mr. Walker.

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

Mr. WALKER. Thank you very much, Mr. Chairman. I am chairman of the American Council for Capital Formation, and I am pleased to appear before this committee today.

I am submitting my prepared statement for the record. Instead of my prepared summary, I would like to comment on Professor Thurow's remarks to this committee. I would also like the opportunity to critique the 20-page proposal that Professor Thurow has agreed to send to Senator Long.

Senator LONG. You disagree with what he said?

Mr. WALKER. Yes; I disagree with Professor Thurow on one or two points.

First of all, this is a very serious proposal that has come down from the administration. It was basically conceived by President-elect Reagan's Economic Coordinating Committee headed by George Shultz. The committee included highly regarded and well-known economists like Alan Greenspan, Paul McCracken, Milton Friedman, Arthur Burns, and others. They weren't "playing tiddleywinks" with the U.S. economy.

Second, Professor Thurow stated that Federal spending will rise between fiscal 1981 and 1986 by about the same amount as it rose from 1975 to 1980. He suggested that, if the 1975-80 period repre-

sents an inflationary boost to the economy, then so too will the period 1981-86.

I think it is very important to understand the difference between a deficit arising from Federal spending and one resulting from a tax cut. When the deficit increases through spending, every dollar is spent, but when there is a deficit resulting from a tax cut, some portion of that is saved. the big debate is, as it should be, how much of "10-10-10" will be saved.

Professor Thurow said that, on average, the savings rate can be expected to be no more than 6 percent, or $6 out of $100. In terms of the marginal savings rate, the rate of saving is far different. He also said it is very difficult to get people to save out of a tax cut. That really depends on whose taxes you cut.

If you cut taxes on high-income individuals, or what some people call fat cats, a very large proportion will be saved, not just in savings accounts, but in the form of not spending on consumption, by putting the money into various forms of investment.

Saving is the act of not spending on consumption goods; it is saving even if put in a mattress, and not invested.

For example, the capital gains cut in 1978 resulted in a big increase in saving and a large increase in taxes paid by the high-income people. And the Kennedy tax cuts of 1964-65, which reduced individual marginal rates from the 91- to 70-percent level, resulted in a substantial increase in saving.

The average savings rate now is about 4.7 percent. That includes individuals with $5,000 of disposable income, $10,000 and $20,000. those individuals are basically dis-savers. They go into debt.

Above that, when you get into higher income levels, levels of $30,000, $40,000, and $50,000 of income, the savings rate is higher, on average, which offsets the dis-saving in the lower brackets.

There is historical evidence regarding the impact of a cut in marginal tax rates on saving. After the tax cut of 1964-65, which was a supply-side tax cut reducing the top individual rate from 91 to 70 percent, the lowest bracket rate from 20 to 14 percent and proportionally in between, the average savings rate went up 2.8 percent over the next 3 years. It shot up over a full point in 1965. This was an actual laboratory experiment.

But, these figures concern the average savings rate. This committee heard testimony last week from Merrill Lynch Economics, Inc., stating that their analysis showed that 45 percent of the tax cut was saved in 1964 and 58 percent was saved in 1965. The average savings rate grew from 5.4 percent in 1963, the year before the tax cut, to 6.7 percent in 1964 and 7.1 percent in 1965.

Under the administration's 10-10-10 proposal, tax cuts are concentrated on middle-income people with $15,000 to $50,000 a year in income. These are the people who pay 60 percent of the taxes and who would get 61 percent of the tax cut. These people are the savers of this country, with hundreds of billions of dollars in savings and loans, commercial bank savings departments, credit unions, money market funds, and so on.

When asked in a recent poll by Opinion Research Corp. whether they would save or spend a tax cut, 82 percent of the respondents said they would save some of the money or use it to pay off debts.

That figure may be too high, but both logic and commonsense, and experience in 1964-65, indicate that you're going to get a big savings response from the 10-10-10 cut.

Professor Thurow says that now people spend a lot more and save less because of fear of inflation. He also says that the recent high rates of inflation create a new climate. I think, however, if middle-income people are your basic savers, there is another reason people have been saving less.

You know what bracket creep is doing to the middle-income taxpayer. He is being buffeted all over the place by the interaction of taxes and inflation. I submit that the basic reason for the low saving rate is more on the side of what Uncle Sam is taking away from the middle-income taxpayer and not letting him save.

If you cut tax rates according to the 10-10-10 proposal, you are going to put taxpayers in a better position to save, and if also you do decide to enact some special savings incentives, that in turn will boost that incentive.

I cannot agree with Professor Thurow that just allowing open and unlimited Keogh accounts will do the job. I'd like to see an expansion of the Keogh, but people with money in other types of savings might simply redesignate the saving already there as a Keogh. It would be much better to say that we are going to let you exclude from your taxable income some portion of the interest and dividend income received, exactly the way we do with capital gains now.

All things considered, what we're debating here with respect to the 10-10-10 proposal is the impact of this approach on the savings rate. I think Professor Thurow is wrong, and I would like the opportunity to comment further for the record when he outlines his plan in more detail.

The CHAIRMAN. I just wanted—you say if you cut 10-10-10 you would save more than if you would pass 10-10-10.

Mr. WALKER. If you pass 10-10-10, there will be more savings——

The CHAIRMAN. Right. I think we said——

Senator Packwood, I wanted to ask you one question before I go to a meeting.

Howard Baker just called me and wants me to come to his office.

I want to give you my 3-minute theory on your decision, because you are one of the best academics I know.

I want to remark on the theory I touched on earlier today. The capital stock corporation is basically a Western institution and seems to be an American institution if you look at history. It didn't really start in Europe until about 1725 when you had the South Sea Co., but then the bubble burst and you had a scandal that cast a pall over capital stock companies in England for 100 years because their navy politicians were involved in it.

You didn't see corporate growth in Europe until the 1800's and the same in this country. You did not see it grow in Asia at all, and it's interesting when you read "Dynasty" the tremendous talk about banks and bank loans or when you read "Noble House" they're talking about a big trading company contemplating going public. It would be the first trading company in Hong Kong to do so, which gives you part of their history.

And then, this Library of Congress report that indicates that Japan finances a great portion of their business by bank loans, it's no wonder that they have savings incentive. That is their historical method of finance, of expanding business.

Our historical method of financing at least expanding business, major business, is stock, equity, not loans. It may on some occasion be bonds or debentures, but it is not normally bank loans. It is equity.

Now, and I think that is why even though our savings rate was lower, lower in 1951 to 1955, 1956 to 1960, 1961 to 1965, 1966 to 1970, it was lower in all of those years than it was 1971 to 1975. That was when we had the highest 5-year cycle of a savings rate, at the time that our investment, our capital formation was going down, our productivity was floating down, and if the answer is savings then there is something wrong, because 1971 to 1975 should have been great years for investment and productivity if it is related to the savings rate.

And I will postulate this. Our savings rate was very high in this country when we had no interest exclusion, but indeed we had a dividend exclusion and a relatively low capital gains tax, and yet we had an adequate savings rate for this country to finance housing and move small businesses, because they do have to get started with loans.

When their businesses grew they changed to equity corporations and they could find people to invest. And the reason that that did not happen in the 1970's was because we had so tilted against capital gains that there was no longer an incentive to finance American business by our culture's traditional way. There was no reward for it. And, we did not turn to savings because that was not our traditional way.

And, I think, rather than tilting too strongly toward savings, we would be better off if we get our interest rates back to a reasonable amount and get our inflation rate back to a tolerable level, we will accumulate the normal rate of savings we need in this country for housing and for small business.

But what we need to do is tilt toward the traditional method of capital formation in this country. Now, let me ask you this, and I have not finished running these figures, but I think I'm not far off. This is only on the personal side, not the 10-5-3.

What if instead of 10-10-10, you have a 5-5-5 starting January 1, 1982. You cut the capital gains tax in half immediately. You reduce the minimum income tax rate to 50 percent immediately and you phase out the double taxation of dividends over a 3- to 5-year basis. I haven't figured out which yet.

I realize that's a great incentive for corporations to declare no dividends for 3 to 5 years, if you can say at the end of it, there's not going to be any tax on it, but that doesn't bother me because it's a form of savings, and that there is no increase in our savings incentive of $200 and $400, and I might even phase that out. Would that be a better method of capital formation for increasing productivity than the 10-10-10 assuming that they cost about the same.

Mr. WALKER. Let me respond to that by saying first of all I agree totally with your historical method of corporate finance, analysis of economic progress in this country, the historical method of corpo-

rate finance, and the impact of capital gains taxes on the financing of American business. A further cut in the capital gains tax is very much something American business needs to help finance expansion. Second, I proposed here last summer and have talked about it since, that maybe a 7½-7½-7½ 3-year cut would be more desirable. Since you are talking about 5-5-5, we are basically in the same ballpark.

Third, and the basic point responding to your question, I would still keep savings incentives in the picture, but I'm not enamored of the type of savings incentive that delegates so much to a specific savings account.

Senator PACKWOOD. You would go to a percentage rather than a dollar amount—and I agree with you if we're going to have one.

Mr. WALKER. The basic answer is that we must raise the level of investment. If you raise corporate investment through 10-5-3, you must also have an increase in private savings to balance that out in terms of the real resources.

For example, at the present time disposable personal income is just over $2 trillion. This means that for every one point increase in the savings rate, there is a $20 billion increase in savings. If we could get that savings rate back to the 8-percent rate it was in the early seventies, that would raise personal savings from the current level of about $90 billion to $160 billion. I think that would be adequate.

Fundamentally, I agree with you, but I would prefer to move toward phasing out taxes on interest and dividend income or at least treating it as we do capital gains with an exclusion.

Senator PACKWOOD. All I'm saying, Charlie, is I think if you stopped inflation and lowered the interest rates, you'd get savings back to 7½ percent with no new incentive, and you would lose your incentive to tilt toward equity formation.

Mr. WALKER. Well, let's not call it an incentive. I do not think we should tax income from capital. It is not part of income in the classical economic sense, so I would move toward taxing dividend and interest income at a lesser rate as you do capital gains on that argument alone.

Senator PACKWOOD. Mr. Chairman, thank you. Thank you very much.

The CHAIRMAN. Mr. Massa.

STATEMENT OF MR. CLIFF MASSA III, VICE PRESIDENT OF TAXATION AND FISCAL POLICY FOR THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. MASSA. Senator Packwood, I will just go ahead. My name is Cliff Massa. I am the vice president of taxation and fiscal policy for the NAM. The NAM supports the President's across-the-board marginal rate reduction as a means of reducing taxation on all forms of savings and investment, to reduce the attractiveness of the artificial ventures that many potential investors go into to avoid high marginal rates, to reduce the appeal of tax-free benefits as compensation and of the underground economy, and finally to address the rate of tax that is imposed on the millions of unincorporated businesses taxed under the individual rates as partners and sole proprietors.

I would like to focus most of my comments on the President's proposal for 10-5-3 which is no stranger to this committee and the members of this committee who have supported it over a period of years. Particularly, I will comment on observations made earlier this morning by Professor Thurow and others who I think will follow in testimony this afternoon—later this morning and this afternoon.

We understand the two principal objectives of major changes in depreciation and in particular 10-5-3 to be as follows:

First, to eliminate useful life depreciation, simply to establish one set of rules for all types of machinery and equipment which we believe achieves neutrality.

Second, to create such a simplified system that all forms of businesses, whether large or small, manufacturers or retailers, incorporated or unincorporated, are finally able to use the same system and everyone's benefit under that system will be provided under a simple set of rules that eliminates Treasury's administrative power over depreciation.

One of the points made by Professor Thurow this morning, and that has been made in other places, is a very strange emphasis on the presumption that 10-5-3 is going to create wall-to-wall shopping centers and office buildings in this country.

In fact, I suspect that if you haven't already, you'll be visited by many of the people who are responsible for developing just such operations who are not pleased with 10-5-3. In fact, they view the distinction that this committee introduced last year between owner-occupied and leased buildings as being discriminatory against that very type of structure.

I would encourage your attention to the fact that both the President's proposal and what this committee drafted last year focus on the owner-occupied structure that is an industrial or a distribution facility which we think is perfectly appropriate and, if anything, the impact of 10-5-3 is a disincentive to presumably tax motivated investments in real estate.

With respect to the issue of neutrality, I recognize that neutrality like beauty is very often in the eyes of the beholder. We may have a few radical differences among those of us as to what constitutes neutrality and depreciation, but let me set forth the point of view that we hold, and it is on this point that we build our support for 10-5-3 of the neutral system—that is a system that does not force the taxpayer to look at the relative cost of investing in asset A versus asset B because he has a different depreciation life.

One 5-year category for equipment says we want to reduce the tax induced motivation to either invest or not invest in a particular type of asset, making economic considerations to invest or not invest, but don't worry about the tax consequences of a particular depreciable life.

Finally, one of the proposals that has generated a good deal of interest is known as first-year capital recovery, which I think you will probably be hearing more about early this afternoon.

We do not support the first year capital recovery proposal as initiated by Professors Jorgenson and Auerbach of Harvard. We feel it does not meet the objectives of 10-5-3 which is a simplifed system that reduces Treasury's ability to set administratively what

goes on in depreciation, nor do we feel it is particularly simplified. In fact, we're concerned that FYCR would turn out to be essentially a system of a dog chasing its tail as used depreciation lives affect used asset prices which affect depreciation lives. I'd be happy to take a little more time later, Mr. Chairman, on particular questions.

Senator DANFORTH. Mr. Grace.

STATEMENT OF MR. J. PETER GRACE, CHAIRMAN, W. R. GRACE & CO.

Mr. GRACE. Thank you, Senator.

I brought some charts and we had permission to present them. May I say while they are being put in place that I am grateful for the opportunity to speak on this subject.

The first chart, Senator, shows what happened——

Senator LONG. Might I ask that those should be put where the audience might be able to share them with us. How about over there against the wall? There's no one sitting there.

May I just suggest that whether we agree with the witness or not we ought to try to see to it that his arguments are presented so that everybody has a chance to see his charts. Also, we ought to try to decide these things, not based on who is right, but based on what is right. And if you're right, we want you to prove it; if you're not right, we want you to have a chance to prove it anyway. Because if you're not right, we would like to see that demonstration also. [Laughter.]

Mr. GRACE. Thank you.

The first chart shows the case of 10-percent inflation and tax bracket creep—a situation which makes it difficult for a family of four to maintain 1972 real purchasing power. [Indicating.]

In 1980 a 1972 family that had earned $30,000 taxable income required $63,600 to stay even. By 1986, if nothing is done about inflation and tax bracket creep, that family will need $119,962 just to be in the same position as it was in 1972 on $30,000.

The next chart shows [indicating] very quickly that in 1972 only the $10,000 incomes were in the 50-percent bracket. By 1980 that 50-percent bracket had crept up to $40,000. And by 1986—if nothing is done to change it—everybody except the $10,000 and $15,000 1972 taxable income groups will be in a 50-percent bracket.

The next chart addresses [indicating] itself to Kemp-Roth. According to our calculations, the income tax reduction over the period [let us say] from the middle of 1981 through 1986 would be $618 billion. But $475 billion of that, or 77 percent, would be offset by tax bracket creep.

In other words, we see Kemp-Roth reduction as being only 23 percent of what it appears to be gross.

Next chart. This shows how we compared with other countries which have no capital gains taxes [indicating] except in the United Kingdom, and you can see that we are at the bottom of the average investment as a percent of GNP—way below Japan. At the top, or at the bottom, both in Government spending as a percent of GNP, and in GNP growth, the United States is just ahead of England, but behind everybody else. In productivity we are on the bottom.

And the next chart shows [indicating] that our share of world output has declined by 30 percent over this period. And, in each period, we've been declining steadily.

Japan's share of world output is up 160 percent, while that of the less-developed countries is up 10 percent, matching the figure for France.

Next chart. This shows [indicating] taxes on investment. You take $10,000 in dividends, $5,000 in interest, $35,000 for capital gains and $50,000 in salary. That's a $99,000 income.

In the United States, we have much higher taxes than does France, West Germany, or Japan. We are at the top of the list or at the bottom—depending on your point of view. We have the lowest savings rate—6.3 percent against a double digit savings rate for our competitors, and our productivity growth for 1973 through 1978 is at the absolute bottom of the list.

The next chart shows [indicating] the high cost of dying. In the United States the cost of dying is 2.33 times greater than it is in France, 4.67 times Germany's, 6 times Italy's, and 7 times Austria's. It's actually amazing the financial difference between dying in this country and elsewhere, and of course, that applies to gift taxes. [Laughter.] I might say that the only thing certain is death and taxes, but death doesn't get worse every time Congress meets. [Laughter.]

The next chart show [indicating] where a family of four's income has gone since 1971. You see the increase in taxes on income as percent of spending. All of the other items—clothing, personal care, et cetera have been reduced as a percent of spending. But payments to the Government have gone up 45 percent.

The next chart [indicating] shows the cost of reducing the maximum income tax which is currently 70 percent. If you reduced it to 50 percent it would cost you $3.4 billion—only 6 percent of the budget, and it would require only a 0.9-percent increase in economic activity to offset the reduction. If you reduce it all the way down to 36 percent, it only costs $22.5 billion in revenue which is still only 3.9 percent of the budget; you would need only a 6-percent increase in economic activity to offset the reduction.

Now, the lost tax revenue from the "underground economy" is around $30 billion. That amounts to 8.8 times the revenue loss that would result from reducing the maximum rate to 50 percent and 1.3 times the loss caused by reducing the maximum rate to 36 percent.

The next chart shows [indicating] a comparison of taxes under the Reagan program. As you will see, it is progressive: Much of the higher reductions come in the lower bracket while the lower reductions occur in the higher brackets. So, the newspaper reports that label the reductions a gift to the rich at the expense of the poor are wrong. Just the opposite is true.

Now, to measure the after-tax real returns on capital gains. In the 1950's and the late 1960's, they were about 11.3 and 11.0 percent per annum if you tripled your money back nominally before tax in the average holding period of 7.2 years per the U.S. Treasury. What you got after tax in the 1950's and 1960's was about 11 percent per year.

In 1980, with a 28-percent capital gains tax, if you tripled your money back you were in the red by 0.3 percent per year. If there were a reduction in the capital gains rate to 20 percent and we had a 10-percent inflation rate, you would make 3.8 percent per year after taxes on a nominal tripling of your money back. So, a 20-percent capital gains will not do the job.

We need the capital gains cut because 81.5 percent of new jobs are created by relatively small firms of 100 or fewer employees. These small firms go to the capital markets to raise money.

The next chart shows [indicating] what happens when you raise the capital gains tax. In 1969, you had 2.9 billion [in constant 1980 dollars] in funds raised in the form of equity capital by companies with a net worth of under $5 million. This figure dropped by more than 99 percent to practically nothing—$25 million in 1974 and 1975. But, when you lowered the capital gains rate from 49 percent down to 28 percent we recovered to $821.5 million in 1980—an increase of 3,300 percent. During the first quarter of 1981, there were 59 new offerings—totaling $313 million—or more than the 5-year total for 1974 through 1978.

I think the next chart is particularly interesting, Senators. It shows the expanded income level from $0 to $14,999 [indicating]. 50.9 percent of the total taxpayers are in this bracket, and they earn 21.9 percent of the taxable income and pay 10.7 percent of the taxes.

Going to the other extreme, now—the $100,000 and over group—it comprises 0.9 percent of the taxpayers, 6.8 percent of the taxable income, and 16 percent of the total taxes paid. Now, if you move to the bracket preceding $15,000 to $49,999—you find 3.8 percent of the taxpayers, 8.8 percent of the taxable income, and 13.3 percent of the taxes paid.

Now, when you subtotal those three you only have 55.6 percent of the taxpayers, 37.5 percent of the income earned, and 40 percent of the taxes paid. That leaves us with the $15,000 to $49,000 group. That's 44.4 percent of the taxpayers, 62.5 percent of the taxable income, and 60 percent of the taxes.

And, of course, as you know Senators, total income taxes only account for 42.1 percent of the budget. Other contributors are the social security tax [28 percent], business taxes [11 percent], other revenues [9 percent], and the deficit of 10 percent accounting for the remainder of the total hundred percent.

One hidden factor in the economic picture is the "underground economy" of $30 billion—that's a conservative estimate—which accounts for 5 percent of the budget. That amounts to 77 percent of the taxes paid by the $10,000 and over income bracket group—115 percent of the taxes paid by the under $15,000 group which is 50.9 percent of all taxpayers.

The final chart [indicating] illustrates why we recommend cutting the top personal tax rate to 36 percent. We feel what's needed is only a 6-percent increase in activity to offset the lost tax revenues. All personal or corporate earnings should be adjusted for inflation before taxes, and the capital gains tax should be eliminated.

Senator, I thank you very much.

Senator LONG. That was like running an express train by a picket fence and asking a passenger to tell you which picket was broken. [Laughter.]

Senator DANFORTH. Senator Long, your turn is up. [Laughter.]

Senator LONG. Well, let me just ask about up-front capital recovery. Mr. Jorgenson is scheduled to appear this afternoon. Last time I heard him, he was so profound that I didn't know what he was talking about, but some people said that he had a good idea.

I discussed the idea of first-year recovery at a conference a week or so ago, sponsored by Time magazine.

I didn't know how to discuss it in Professor Jorgenson's terms, so all I could do was explain first-year recovery the way I would understand it—that is, basically just to write it all off the first year. It seemed to have a tremendous appeal to those businessmen at that particular conference.

If you're going to give a fellow a better depreciation arrangement, why not just let him write it all off the first year?

That idea had tremendous appeal. That's something business people can understand.

Now assuming that whatever you let him write off works out to about the same cost as the 10-5-3 proposal, what's wrong with doing it that way? It would be much simpler, wouldn't it?

Mr. MASSA. Well, Senator, if what you've described is what Professor Jorgenson had described——

Senator LONG. I don't know what he described because I heard him, and as I told you I couldn't understand what he was talking about—[laughter] because I'm not familiar with the kind of language he uses.

Mr. MASSA. Senator, what you've outlined is a simple understanding that first year capital recovery, means write it all off or "expensing." I think if that were seriously put on the table, you would get a lot of business groups coming up here and saying "let's talk about that. That's a good idea." That's not what the professor is talking about.

He's talking about first year capital recovery, but at some percentage of a full writeoff. If you want to put full honest to goodness expensing—write it all off in the first year—right out on the table, we'd be very happy to talk to the committee about that.

Senator LONG. That's what I would like to talk about.

If we are going to do something that's going to cost a lot of money in terms of revenue loss anyhow, rather than have a businessman keep all these records of when he bought the piece of machinery and how much depreciation he still has left in it, and all that kind of thing, assuming you have the same cost in any event, I find tremendous appeal in just letting him write it all off the first year. If he has anything left, let him save that for later, carry it forward and write it off the next year.

Dollar for dollar, if you're thinking in terms of how much revenue you have to work with—and as long as I've been on the committee, in the end we had to think in those terms—it seems to me that first-year cost recovery has a lot to recommend it.

Mr. MASSA. Senator, I'd feel a lot more comfortable if you'd go with expensing rather than first-year cost recovery, because the

latter is what Professor Jorgenson is talking about. We would like very much to pursue expensing with the committee.

Two years ago, when the 10-5-3 effort started, if anyone seriously told us that the Finance Committee might really want to talk about expensing, we wouldn't have believed it. But, if that's a serious option, I think it is one that needs to be pursued. The only question I would raise is in terms of your revenue effects. You might have to look at putting the system in over 2 or 3 years, but I think that's a mechanical problem. I think the theory is right.

Senator LONG. Let's talk about up-front expensing, now. The thing I like about it is this: You buy the piece of equipment and you just take the full deduction right then and there. That's all there is to it. You don't have to have the books to keep up, you don't have to maintain a record for years saying when you bought it. You don't have to show that this piece of equipment has 80 percent of the cost left in it and this piece of equipment has 60 percent and so forth.

I wish with the technical competence that you witnesses have, you would favor us with your thoughts about what we might be able to do along that line. What bothers me about this pellmell rush is that it all proceeds upon the assumption that we have all decided what we want to do.

I haven't decided how I want to vote. The bill we're talking about is not the same bill we voted on in the committee last year. May I say that sometimes a pellmell rush to get something done wastes a lot of time.

What we really want is to try to do the best thing for the country. I know I do. And, as far as I'm concerned, while I have been chairman of this committee, my impression is that all we wanted to do was just to think in terms of what would be best for the country. We will take in your advice.

Mr. MASSA. To the extent that we can bring our technical confidence to bear, we'd be glad to talk with you, your staff members, anybody on what it takes to get full expensing in. I think that's a very good idea.

Senator LONG. Do you agree with that, Mr. Walker?

Mr. WALKER. I agree with it. You will hear testimony this afternoon from David Raboy to the effect that 10-5-3, under reasonable assumptions regarding inflation, comes very close to expensing. The 10-5-3 proposal does so in an evolutionary way instead of a revolutionary way. It includes the investment credit. I think when you look at expensing and compare it to 10-5-3, you will find that 10-5-3 is very close to expensing.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. As I—England permits expensing; does it not.

Mr. MASSA. England has some limited expensing; I think it's only in industrial activities, but they have had expensing for a few years.

Senator BYRD. They are permitted to expense a factory for example. I think that's going too far.

Let me ask you this about 10-5-3 versus 10-7-4-2. What is your panel gears to which of those two methods should be used.

Mr. WALKER. I favor 10-5-3, sir. I think 2-4-7-10 as developed by Senator Bentsen and endorsed by this committee, is a very strong step in that direction. The basic criticism I would have of 2-4-7-10 is that this proposal retains "useful life" for depreciable assets. Eliminating "useful life" is critical, especially for smaller firms, for two reasons.

One, small business wants an uncomplicated system. They would like to see one basic write-off period for equipment, the 5-year category under 10-5-3.

Second, with all due respect to my former employer, I would like to reduce the power of the Treasury Department to decide how long these writeoff periods, or class lives, should be. I think Congress should decide that. As long as you have numerous class lives, and Treasury has the power to establish them, you will have arguments between the taxpayer and the Treasury.

The 10-5-3 proposal gets around that very simply by establishing only three asset classes. But 2-4-7-10 is quite a very constructive proposal and much better than current law.

Senator BYRD. Then all three of you support the 10-5-3?

Mr. MASSA. We do, Senator.

Mr. WALKER. Yes, Senator Byrd. Or Senator Bentsen's alternative, I think they're both great moves.

Senator BYRD. I could support either one. Let me ask this question: Do you consider the President's tax program to be inflationary?

Mr. MASSA. I do not.

Mr. WALKER. I do not.

Mr. GRACE. No, sir, not when combined with the budget cuts and proper monetary measures, no; I do not. As I showed, Senator, the net tax cut is only 23 percent of the program—after the bracket creep.

Senator BYRD. If the President's program were to be compromised, or must be compromised in order to get something along that line or through, do either of you have a suggested way that we best go.

Mr. WALKER. Senator, in my colloquy with Senator Packwood, I talked about the possibility of a 7½-7½-7½-percent cut for individuals. And I first suggested that before this committee last summer.

I have two basic reasons for that. I would like to see at least a 20-percent cut over the next 3 years in marginal income tax rates.

I think we need the cut for social and political reasons as much as economic reasons. Even the middle class is beginning to look for tax avoidance, tax shelters, the underground economy, and so on.

So I would like to retain at least 20 to 25 percent of the marginal rate cut. And I think such a cut will be a very big boon to savings, as I mentioned earlier, because the middle class, which will benefit from this cut, includes the thrifty people who save. They need a chance to save it again.

Then I would feel that the 2½ points between the 10-point cut proposed by the President and the 7½ cut if you decide to go in that direction, could be used for savings incentives. If you cut the top rate from 70 to 50 percent immediately, I think you'll get revenue back, and practically all that is going to be saved or, conversely, not spent on consumption.

I would increase the capital gains exclusion from 60 to 75 percent, as Senator Wallop has proposed in his bill, or at least to 70 percent and that again will increase savings. And I would try to develop a savings device for the middle-income taxpayer per se, and I think the simplest, most neutral, easiest to understand, is to phase-in over a 5-year period an exclusion for interest and dividend income, equivalent to the amount excluded for capital gains with a minimum of $200 or $400. These proposals would create a balanced program to promote individual savings.

Senator BYRD. I assume that all of you feel it's important to get the top marginal rate for investment income down to the 50-percent range, although, Mr. Grace, you advocate going down to 36 percent.

Mr. GRACE. Well, it wouldn't cost very much to reduce it to 36 percent; it would only require a 6-percent increase in activity, and I just illustrated that to show that's how we can get rid of the underground economy.

Senator BYRD. My time has expired. I have a couple more questions which I will reserve at a later time.

Senator BAUCUS. Thank you, Mr. Chairman.

I don't know who to ask this question. I guess probably you, Mr. Walker, since you were the leadoff witness of the panel.

I understand—Senator Long and others had some interest in the Jorgenson-Auerbach approach. I also understand that there was some disagreement of the panel with that approach. I'm curious as to what the disagreement really is. Is it because it doesn't go far enough in encouraging capital investment, or is there some other reason?

Before you answer that, I would like you to consider in your observations whether the 10-5-3 does in fact subsidize capital investment? There are many analysts who say that business would get back roughly $1.06 for every dollar invested, since after tax interest rates are 17 percent or lower and provide a big boost, big subsidy for business. I asked Secretary Regan the same question. That is, I asked him if the administration wanted to subsidize capital investment. I think his answer was no. His answer further was that 10-5-3 does in fact subsidize investments, give back more than invested. The administration's position then was to back off of 10-5-3, an indication that they don't want subsidize investment. So, the basic question is, What is your reaction to the Jorgenson and Auerbach approach?

Mr. WALKER. To save time I refer you to pages 13 to 18 of my written statement and will just highlight some of the points there.

The first point notes how complicated the Jorgenson-Auerbach system is to construct. It looks easy to compute. You just write off so much according to the table. But the complication of putting it together almost boggles the mind, which leads to a second problem noted on page 15 of my prepared statement.

You take the case of a farmer who purchases for his business some furniture, a tractor, a truck, and an auto. Now, each of these different assets have a different class life and that's a disadvantage——

Senator BYRD. Move back—what about the Shannon approach which reduces the classes to only four categories?

Mr. WALKER. It's the same. It reduces the degree of the problem, but it doesn't eliminate the problem because you would still have an argument about what is a proper class life.

So, from 35 to 4 class lives is a step in the right direction, but doesn't go far enough. The proposal does not allow immediate expensing. You've got to take the present value the cost of the asset. In the case of the farmer in my example who buys some furniture for his farm for businesses purposes, he would be told that he can write off 64½ percent of that investment. In the case of his tractor, he can write off 72 percent.

Senator BAUCUS. Excuse me, Mr. Walker. We don't have a lot of time, so I would like to interrupt and ask a couple of questions here. The question is, Is my understanding correct that that approach has certain complexities because it assumes an effective tax rate of approximately what the effective tax rate of the President's capital investment depreciation system is?

Mr. WALKER. No; that's not the fundamental problem.

Senator BAUCUS. Well, but because of that, he has to set up all these categories and so forth. I'm wondering though, what if you go to first year——

Mr. WALKER. Expensing.

Senator BAUCUS. Expensing.

Mr. WALKER. Oh, we would be delighted to talk about that. And, we think 10–5–3 is an approximation of that.

Senator BAUCUS. But, do you agree that 10–5–3 is more than an approximation?

Mr. WALKER. No; it depends entirely on your assumptions regarding inflation rates and the discount rate you use.

Senator BAUCUS. Do you think that the effective tax rate in a 10-5-3 is not negative.

Mr. WALKER. No; I do not agree——

Senator BAUCUS. Not in the 5 or 3 categories it is not negative either; is that your view?

Mr. WALKER. I do not agree. It certainly is not in the 10-year category and in the 5-year category it depends entirely upon the discount rate that you assume. For Jorgenson's purposes, you've got to convert all of that stream into present value and you've got to have a discount rate for that. What discount rate does he assume? He takes a range of yields on U.S. Government securities. Those are the most risk-free assets we have. If you do as Dr. Raboy has done, and use a proper discount rate, the calculations will show that the 5-year category is approximately equal to expensing.

Senator BAUCUS. Now what about the 3-year category.

Mr. WALKER. The 3-year category turns out about the same, because the 5-year category used a 10-percent investment credit and the 3-year category uses a 6-percent credit.

Senator BAUCUS. The only point I want to make is that depending upon one's assumptions a discount rate is possible that the 3- and the 5-year category effective rate would be negative, would be an investment, be a subsidy under the 3 and the 5 and the 10–5–3.

Mr. WALKER. It's possible, but that's true of any approach. It's not peculiar to 10–5–3.

Senator BAUCUS. Thank you, my time is up. Thank you.

The CHAIRMAN. Senator Bentsen.

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Senator BENTSEN. Thank you, Mr. Chairman.

I can't help but think about the fact that Professor Long let me form the Capital Formation Subcommittee back in 1973 on this committee. I remember some of the wags asked me if it had something to do with the Architect of the Capitol. [Laughter.]

Now, people are concerned about it and I'm delighted some of my thinking is finally in vogue.

I think Cliff Massa made a good point that one of the problems of the Dr. Jorgenson approach is that you've got an arbitrary assumption made by the Secretary of Treasury each year on what the discount rates going to be. And, you have a variable there that would give me some concern.

Dr. Thurow says that it takes a long time to increase productivity. That's right. We didn't get into this over night and we won't get out of it over night. But a 1-percent increase in productivity has an incredible payoff.

Go back to 19th Century and see what the productivity rate of England was against the Continent. It was only about as I recall about a point and a half difference and led to a very major change in who had the industrial base and who won competition.

But, I am deeply concerned about the interest in savings in this country. I'm talking about dollar savings and savings accounts, any kind of management institutions that will handle it. I believe that you're going to have to have some kind of incentive. That's why I think that you're going to have to take this 10-10-10 and modify it.

You have got to take care of some of this bracket creep Mr. Grace is talking about. But it ought to be somewhere between five and seven and a half it seems to me a year, then you ought to take the rest of that to try to have an encouragement for savings.

I think the administration has won the hearts of Wall Street, but they sure haven't won their minds. And all you have to do is look at the long-term money market and the chaos in the bond market to understand that.

If you we can reverse the inflow of savings, create the inflow of savings, plus cutting back on Government expenditures, we would restore that faith in long-term bonds in this country that we desperately need.

So, I think that we have to have that kind of a moderation.

I must say that on the 10-5-3, I do get concerned about office buildings. I go to Houston and I see an incredible outflow of capital going into office buildings. I can't recognize the town from time to time almost. I see it here in Washington. I don't see the further incentives needed there. I can sure understand it for plants. I think that's critical, we have to have it.

But, I would like to see some modifications where we don't have that much of an incentive left in the office buildings, and I know that violates what you gentlemen are proposing.

Other than the coalition, you have to hold together. Can you give me some good arguments why that has to be.

Mr. MASSA. Senator, if I could respond on that point, the basic coalition really doesn't give a hoot about increased construction of office buildings or shopping centers. In fact, both the administration's bill and this committee's version last year would specifically exclude office buildings from the most favorable category. In the

administration's, it's 10 years. In your bill last year it was 15, because office buildings do not meet the definitions of being industrial or commercial. We think that was by design. Many of the groups that represent the builders and developers of such buildings are not happy with our lack of support for treating all buildings the same way. But, we certainly are not in favor of revising either the Finance Committee's bill of 15 and 20 years or the administration's 10 and 15 distinctions to include office buildings.

We think the owner occupied definition for an industrial structure, retail and distribution sector structures is fine. The creation of new incentives for the building of office buildings, leased buildings of that sort is not needed. If they can work their way into the bill, that's fine, but that is not what the basic coalition supporting 10-5-3 favors.

We would agree that that type of investment doesn't need additional stimulus, at least that's not what we're looking for.

Mr. GRACE. It's all done on borrowed money, anyway, Senator. I mean these office buildings are all built on borrowed money. There's no equity money.

Senator BENTSEN. Mr. Grace, I sure understand that. I have operated on OPM all my life. [Laughter.]

Other people's money.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Grace you are somebody who has had vast experience from doing what we're trying to encourage around here. And, first, I want to say about your charts, I thought they were interesting. I must say I'll have to digest them a little later. You went a little fast.

Mr. GRACE. Thank you, Senator. That was the time limit, and I'm sorry.

Senator CHAFEE. You set a cross record, I think here. [Laughter.]

And, I think it's very important you pointed out this underground economy which has been overlooked here, I think a great deal.

But, now let me ask you a question. I'd like to stick to the business deductions, now, business cuts. What do you say about the 10-5-3 depreciation schedule. Mr. Thurow indicated that one of the real problems with the 10-5-3 is that with the electronics type of equipment you're going to move up actually to the 5-year depreciation, as opposed to the 2 or whatever it might be now. What do you say to that?

Mr. GRACE. Senator, I'm much more interested in the tax cuts directed toward the families of America, which as I showed——

Senator CHAFEE. I appreciate that, but now——

Mr. GRACE. As far as I'm concerned regarding 10-5-3 or Senator Bentsen's alternative, I think the most important thing is to get the individual cuts and after that obviously it has an important bearing on inflation, but if you get inflation down, depreciation is going to become more adequate.

Senator CHAFEE. The reason I think you're a unique witness here, is that you're a practitioner of everything that all the economists around here are giving us advice on how to make you more effective. So, we would like to hear it from the horse's mouth, that's somebody who is in the marketplace, as it were, whose going

to be the beneficiary or whose going to have the stimulus from these various programs. So, are you saying that as a businessman, you're more concerned with the individual cuts than you are with the business side of it.

Mr. GRACE. Yes, sir, Senator. Last year we appropriated $1.4 billion in capital in our company and it has nothing to do with lowering our years of life or anything else. The depreciation schedules are OK for us to expand. We are expanding at the rate of $700 or $800 million a year in capital expenditures and appropriated $1.4 billion last year.

Now, I'm not down here to be against them, and I'm not here to argue for the 10-5-3 or anything else. I came down instead to talk about what's happening to the American family.

Senator CHAFEE. Mr. Walker is straining to get a word in. Go ahead. [Laughter.]

But, it's got to be very few words.

Mr. WALKER. I'm not a large businessman, I'm a small businessman, but I am a rapid mathematician to a certain extent. I asked the electronics industry to tell me how they're worse off, even if you have to move to 5 years where you will get a full investment credit of 10 percent as opposed to where they are at 3 years with only a partial investment credit. None has shown me the arithmetic as to why that would not help them.

Senator CHAFEE. Now, the thing that bothers me here, and these remarks should probably be directed to Mr. Massa who's a supporter of the 10-5-3. Last year as has been pointed out, we went through this. We found that the 10 is very, very expensive, and so as you know we moved on up to the 15- year owner-occupied and nonowner-occupied, I think, was it 20 we did—I think so.

Now, what I really think is that the money should be directed in is the machinery and equipment. And I'm not so concerned about the buildings side of it. What do you say to that.

Mr. MASSA. Well, there's no denying Senator, that manufacturers place more importance on machinery and equipment because that's where the bulk of capital investment is being made. But the fact of the matter is that those machines and pieces of equipment have to go into a building. As technological processes change, buildings have to be modified, and as energy gets more expensive, more energy efficient processes and energy efficient buildings have to be constructed, and particularly with respect to the electronics industries as we understand it, which are growing rapidly both around route 128 in the Silicon Valley and other——

Senator CHAFEE. Well, we've only got so much money invested in that.

Mr. MASSA. That certainly is a decision the committee in the Congress will have to reach. How much you're going to put into it.

We feel that the failure to make a radical change in the depreciation of buildings will leave this bill incomplete and inadequate. We do need a basic fundamental change and a speed up in the depreciation of productive buildings.

Senator CHAFEE. Thank you, Mr. Chairman. Who is the chairman around here.

Senator DURENBERGER. Senator Danforth.

Senator DANFORTH. Dr. Walker, I guess you have been, I guess, the country's leading advocate for a refundable investment tax credit. Have you abandoned that idea for that tax bill?

Mr. WALKER. Personally, I have not. I'm testifying today for the American Council for Capital Formation and as is the case with most groups, it is split. The haves are against it and the have-nots are for it. I defer to Senator Long as the leading advocate of refundability in the days gone by. I would like to see this legislation personally do something more than what would be done by 10-5-3 in the short run, for the auto industry, the steel industry, the railroad industry, the airline industry, the paper industry, and the mining industry.

Senator DANFORTH. Isn't it fair to say that for those industries, the legislation that has been proposed or discussed thus far would do virtually nothing.

Mr. WALKER. Currently, while their profits are marginal or nonexistent because they don't have the profits to take the accelerated depreciation. In fact, the automobile—each of those industries has around $700 or $800 million already earned but not in utilized investment tax credit. So, in the short run that is correct.

Senator DANFORTH. Take the automobile industry, to the extent that we shorten useful lives for depreciation purposes, the effect of that in this country would be to help General Motors and not Ford and Chrysler. Is that right?

Mr. WALKER. That is correct to the extent that those companies cannot rely on the leverage leasing approach as the railroads and airlines can to some extent. It is the case that when a profitable company buys a piece of equipment it costs 90 cents and when an unprofitable or marginally profitable motor company, like Ford or Chrysler, buys it costs 100 cents. So you've got an anomaly there.

Senator DANFORTH. Do you think that should be a priority item, or maybe its a conflict for you to be testifying on this, I don't know. I'll just leave it with you, but I know that you've taken such an interest in it in the past, I wonder if we should have something in a bill that goes to refundable tax credit, as opposed to accelerated depreciation.

Mr. WALKER. I'm a supporter of the administration's two-bill approach and certainly the issue ought to be taken care of as early as the second bill. However, the chairman of the House Ways and Means Committee noted in a speech in Chicago a few weeks ago, that he very much wanted to do something about those particular industries, and he singled out autos and steel. He stated that one solution might be through a longer carryback period, or something else what may be short of refundability. I think this issue will be discussed at least in the markup of the Ways and Means Committee, because some very important sectors of the American economy are affected.

Senator DANFORTH. Do you have cost figures for various refundable tax credits or carryback features?

Mr. WALKER. Cost figures for the carryback are very easy to get. The carryback would be very beneficial to several companies, especially some of the auto companies. It depends on when you fell into your hard times. And, if you fell in relatively recently and got a 10-year carryback instead of a 7 year, you could do a great deal.

Others such as airlines, and some railroads, would have to go back much, much further. As to the cost, it would depend on how you construct the bill. If you took it as a phasein and confined it to the basic industries, it could be brought in at a relatively small figure.

Senator DANFORTH. What kind of figure are you talking about?

Mr. WALKER. Current refundability, which when Senator Long introduced his bill, I believe, a couple of years ago, was around $3 to $4 billion a year, so a 5-year phasein would cost roughly $600 or $700 million. The big problem is what to do with the already accumulated credits, which amount to around $3½ billion in the industries I noted and $12 billion in general. So, you would have to figure some sort of phasein for that also.

Senator DANFORTH. Let me put the question differently. I assume that there are any number of ways to structure it.

Mr. WALKER. Yes.

Senator DANFORTH. The question is what you want to accomplish and that in turn is the question we're trying to balance on one hand, what's necessary to assist the industries in question, and on the other hand, the revenue loss that's incurred by the assistance. So, the question that I want to put to you is, If we wanted to do some good with this bill, if we wanted to provide some help, for the basic industries at least, what kind of revenue loss would be required, say, over the next 3 years.

Mr. WALKER. Well, you're talking about a universe of unused accumulated credits of about 3½ billion. And, it's awfully important to some of the auto companies and steel companies to pick up at least a portion of those unused credits. If you phased in that $3½ billion over a 3-year period, it would be roughly a billion and a quarter a year. And then if you phased in current refundability, currently generated credit, over say, 5 years, and if it was the $4 billion base which Senator Long is talking about, the cost is about $800 million a year, so that the retail would be around $1 to $1.3 billion for this sort of approach.

But, let me add very strongly that if Congress sticks with the administration's two bill approach which I advocate, these sorts of things should be considered in the second bill.

Senator LONG. Could I just comment on that? If we're fair with ourselves, we'll recognize that the investment tax credit is a subsidy, a subsidy to encourage the buying of equipment.

It makes very little sense to provide this subsidy to everybody except those who need it the most, those who are having a difficult time making it.

Why should Chrysler, for example, be left out?

You have some railroad that's trying hard to get its nose above the water, or get a gasp of breath—why should it be left out? Or an airline is having a hard time making it—why should it be left out?

It just doesn't make any sense and if the people who are involved would be willing to work at it—get off the seat of their pants and come up here and do some of their own lobbying to back Mr. Charls Walker up and give some others who would see their point a little help, they could prevail. I regret to say that it is costing them a fortune to sit there on their rear end.

Senator DURENBERGER. Thank you very much, gentlemen. Thank you for that endorsement of my legislation. [Laughter.]

Senator Bradley.

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

Mr. Walker, I was curious about your reaction to the second witness today, Dr. Thurow. When we had a discussion earlier about savings, he said there was very little evidence to indicate that the marginal savings rate among income classes differed significantly, and then you asserted that clearly high-income groups save more.

I wondered for my own benefit if you could back that assertion up with some analysis, say, on savings rate among income classes from 1960 to 1980. What is the evidence for the assertion, that you made.

Mr. WALKER. The only evidence that I've seen and which I will submit for the record if you like, was published by Dr. Michael Evans, of Evans Economics, Inc. It appeared in the Wall Street Journal about 2 months ago. Dr. Evans argued that there was a very big difference in the savings rates among income groups. The fundamental case I am making is based upon commonsense, in looking at how people behave and what they do. I know that personally if you cut my taxes by 30 percent over the several years, I'm going to save every bit of it.

In lower income groups, on average, people may save none of the cut but I think savings will be spread on where your rates hit.

Senator BRADLEY. So you're saying there is really is no empirical evidence. You're making a judgment on human psychology.

Mr. WALKER. No; I think there is empirical evidence. I will submit Dr. Evans article for the record.

[The material was subsequently submitted:]

THE WALL STREET JOURNAL, MONDAY, MARCH 23, 1981

The Source of Personal Saving in the U.S.

By MICHAEL K. EVANS

The latest ploy of the old guard liberals who oppose the 30% across-the-board reduction in personal income tax rates is to argue that it will result in decreased total saving, thereby lowering investment, reducing productivity, raising inflation and generally harming the economy.

Supply-side economists may be permitted a wry smile at this turn of events. For years Keynesian economists have argued that fiscal policy should concentrate on raising consumption as the way to improve economic performance and reach the promised land of full employment. Tax cuts that merely went into saving were "wasted." Now these same economists are mounting a rearguard attack by claiming that broad-based personal income tax cuts are counterproductive because they do not generate enough saving. Thus, it is claimed, the scope and size of personal income tax cuts should be restricted until the government deficit has been diminished and those elusive spending cuts have been passed by Congress.

Yet all the empirical evidence of the past 20 years suggests that this 30% tax cut will indeed raise total saving. The increase in personal saving, plus the rise in saving generated by a faster-growing economy, will be greater than the initial increase in the government deficit caused by the tax cut.

This conclusion is based on three principal strands of evidence:

First, during the first year of any given change in tax rates, individuals are likely to save most of the difference. In 1964, for example, an astounding 68% of the additional income generated from the tax cut went into saving.

Second, the people receiving the bulk of the tax cut are those with incomes above the average, and they are likely to save twice as much as the economy-wide average. This statistic is based on the Treasury's own estimate of who will receive the tax cut. The estimates of the long-term marginal propensity to save (MPS) for various levels of income are based on previous surveys, and also incorporate recent figures which have been compiled by William J. Fitzgerald Inc. of Bethesda, Md. The Fitzgerald figures are based on its regular monthly surveys of 10,000 families.

It is clearly indicated in the accompanying table that more than 100% of total personal saving in the U.S. is done by those with incomes of over $25,000 per year. The negative saving figures could refer either to the fact that some consumers dipped into their previous stock of assets to finance current consumption, that they borrowed against hopes of a better day, or that they purchased a consumer durable with a relatively small down payment. In either case, the pattern of dissaving in 1950 among persons with below-average incomes is well established by the figures.

Students of the permanent income hypothesis, which states that consumers base their spending decisions on what is perceived to be their long-term or permanent level of income, have often pointed out that average saving rates calculated by income classes may be biased because higher income classes include windfall gains, while lower income classes reflect some with temporary loss of income.

To see if these anomalies account for the bulk of the correlation between income and saving, we have also used Fitzgerald's tabulations for saving by amount of education, which is a strong proxy for permanent income. There we find that for the five recent periods shown in the table, 145% of saving is done by those with at least a college education. Thus these most recent cross-section studies reinforce the conclusion that, on balance, all saving is currently being done by those with above-average incomes.

It is clear that more than 100 percent of total personal saving in the United States is done by those with incomes of over $25,000 per year.

Our third piece of evidence suggests that in addition to the increase due to higher income, saving will also rise because of the increase in the after-tax rate of return on saving which will arise from lower tax rates paid by those who save. The data given in the table can be transformed to show that the marginal tax rate for savers will decline from 45% to 32%. This implies an increase in the after-tax rate of return of 1.6%, assuming a current interest rate of about 12%.

Thus, of the total $120 billion in tax reduction eventually stemming from a 30% across-the-board cut in personal income tax rates, about $48 billion would be saved because of higher incomes and another $32 billion would be saved because of an increase in the after-tax rate of return. As a result, approximately 60% of an across-the-board reduction in personal income tax rates would be saved.

Personal income tax cuts by themselves still cannot solve all the economic evils of the world. In particular, unless accompanied by continuing pressure to reduce the size of the public sector and a balanced monetary policy, they will have only a modest effect in reducing the overall rate of inflation—which is one of the major benefits that would be reaped by those consumers with incomes of less than $25,000. Yet to defeat this tax cut on the ground that it will diminish total saving flies in the face of the accumulated evidence of what makes the consumer save.

Mr. Evans is president of Evans Economics Inc.

Savings By Income and Education

(In millions of dollars; total U.S. population)

Net Savings by Family Income

	Total	Under $15,000	$15,000 to $25,000	$25,000 & over
Oct. 1980	427.1	-264.9	38.2	653.8
Jul. 1980	-257.1	-504.4	19.8	227.5
Jun. 1980	713.7	-222.6	188.4	747.9
Mar. 1980	501.2	-187.6	320.4	368.4
Dec. 1979	-56.5	-294.1	-255.9	493.3

Net Savings By Education (Of Head of Household)

	Total	Attend Grade	Grad Grade	Attend High	Grad High	Attend College	Grad College	Masters/Doctors
Oct. 1980	427.1	-0.1	68.6	-33.1	-12[illegible].2	226.5	[illegible]10.5	178.9
Jul. 1980	-257.1	-8.7	-65.8	-104.2	5[illegible].2	-72.6	[illegible]9.6	-98.7
Jun. 1980	713.7	-39.8	-15.7	-52.5	2[illegible]	-54.6	224.3	40[illegible]
Mar. 1980	501.2	7.6	-66.0	-65.2	[illegible]	234.2	270.2	12[illegible].7
Dec. 1979	-56.5	36.0	-50.6	-138.9	-2[illegible]	33.1	2[illegible]3.6	[illegible]9.3

Source: W.J. Fitzgerald Inc. 1981

Washington Post, June 1, 1981

Charls E. Walker

Why the Tax Cut Will Make Us Save

When the House Ways and Means Committee meets to "mark up" the administration's tax cut bill, the central question relating to the proposal to cut individual tax rates by 30 percent over the next three years will be the impact on individual decisions to save. The press and many in the public seem to believe that since the rate reductions will affect individuals, and since individuals are consumers, most of the increase in disposable dollar income will be spent on consumption, thereby strongly increasing inflationary pressures. But supporters of the "10-10-10" tax cut maintain that individual savings will rise markedly and help provide for non-inflationary financing of the federal deficit.

Both logic and experience support the administration view.

Just who will benefit most from the cut in tax rates? Middle-income taxpayers, defined not in the statistician's image of $20,000 per year in median family income, but in their own image of perhaps $15,000 to $50,000 a year. These families pay 59 percent of all federal individual income taxes and would receive 61 percent of the tax cut. These are families that save, with the amount of saving rising sharply as income levels rise. They are the people who have saved in the past and now hold hundreds of billions of dollars in savings in banks, savings and loan associations, credit unions, savings bonds, money market funds and other forms.

It is ridiculous to charge that these middle-income Americans are going to devote all or most of any tax reduction to spending on consumption. In fact, a recent survey by W. J. Fitzgerald, Inc., indicates that, on balance, families below the $15,000 income level are net dissavers; their consumption spending exceeds disposable income, with the shortfall made up by cashing in on past savings or going into debt. This means that at income levels above $15,000, net saving must be sufficient to offset the dissaving at lower income levels in order to result in a net saving rate for all consumers of 5 to 6 percent, the U.S. average of recent years. Since the tax cut is to affect mainly these higher income taxpayers, the amount of the tax cut that will be saved can be several times higher than indicated by the current average saving rate.

How much higher? This depends on the *marginal* saving rate, or how much of each extra dollar of disposable income received is saved. Common sense tells us that marginal saving rates rise with income, but from what base and how steeply? Writing in 1971 on the basis of 1960-61 survey data, economist Ralph Husby estimated that the short-run marginal saving rate (i.e., the immediate response) was 67 percent among families with the lowest incomes, gradually increasing to 82 percent at the $41,500 level (the income levels are adjusted to reflect 1980 dollars). According to the Husby analysis, long-run marginal saving rates are lower than short-run rates, ranging from 16 percent in the lowest bracket to 55 percent in the highest. Still, the 16 percent bottom-bracket long-run marginal saving rate was more than twice the level of the average savings rate in the early 1960s, when the survey was conducted.

Personal saving out of the 1964-65 Kennedy-Johnson tax cut was fully consistent with the Husby conclusions. With a 30-percent cut in the lowest bracket rate, 15 to 18 percent for middle-income taxpayers and 23 percent for the highest income taxpayers, the Kennedy-Johnson tax reduction was weighted more toward low-rate savers and dissavers than is 10-10-10. Still, that tax cut had a very big impact on individual saving, with the average personal saving rate rising from 5.4 percent in 1963 to 6.7 percent in 1964 and 7.1 percent in 1965. Comparable results with the Reagan tax proposal would provide an increase of more than $25 billion in personal savings in 1982 and upward of $40 billion in 1983.

Critics maintain that today's expectations of high inflation have blunted incentives to save.

> *"It is ridiculous to charge that middle-income Americans are going to devote all or most of any tax reduction to spending on consumption."*

This "spend now" philosophy, they argue, drove the individual saving rate to a low of 4.7 percent in the first quarter of 1981 and will surely prevent any repetition of the 1963-65 experience, when prices were rising at less than half the current rate.

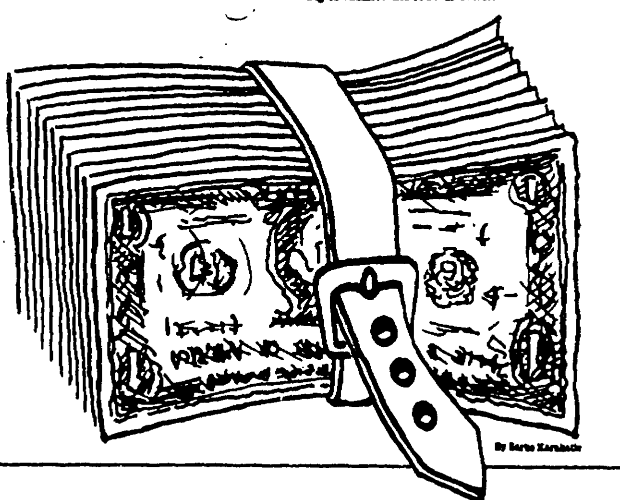
The answer to this criticism is that fear of inflation, if indeed it does cause lower saving, is certainly not the only factor. Of at least equal—if not greater—importance is the increasing tax burden on middle-income Americans as they move up to higher tax brackets and are hit with steep marginal rates. To the extent that this tax burden is the culprit, 10-10-10 carries its own solution to the problem of the low saving rate. Middle-income taxpayers will have more disposable income from which to save and will also get a significantly higher after-tax return on each additional dollar that is saved.

Insight into current attitudes toward saving can be found in recent public opinion polls. In August 1980, the Gallup organization asked people what they would do with a 10 percent reduction in their income tax bills, spend it or save it? Forty-one percent said they would spend most of it; 40 percent said they would save most of it.

But, in fact, that question was poorly worded. Few individuals realize that the act of saving is really a negative act; it is the act of not spending on consumption. Debt repayment is saving. Opinion Research Corporation asked people in late March: "If your tax rates were reduced by 30 percent over three years, would you spend all of the money, or would you save some of it or use it to repay debt?" Fully 82 percent of the respondents said they would save some of the money or use it to repay debt, compared with only 15 percent who would spend it all. Those who said they would save some of the money also said they would save (on the average) almost half of the proceeds of the tax cut.

This response is fully consistent with the range of short-run marginal saving rates as estimated by Husby. Moreover, to the extent the prospect for cutting the inflation rate is recognized by the public, higher saving rates can be expected. In addition, there are strong pressures in Congress to shape the tax bill even more toward stimulation of individual savings. Discussions between congressional leaders and administration officials point to retention of the multi-year approach but with perhaps a five-point cutback in the total size of the marginal rate reduction from 30 to 25 percent. As a trade-off, strongly pro-saving provisions might be added, including immediate reduction in the top individual rate from 70 to 50 percent on investment income, a further substantial cut in the capital gains rate, and some type of savings incentive especially attractive to middle-income taxpayers.

In this way, two important goals would be served. The pressing social and economic need to reduce the impact of "bracket creep" on tax-battered middle-income Americans would be met. At the same time, maximum stimulation of individual saving would be obtained, and the tax cut would in significant part "pay for itself" by helping to finance the federal deficit.



The writer, a Washington consultant, was deputy secretary of the Treasury in the first Nixon administration.

Senator BRADLEY. Also, last week you had testimony from Merrill Lynch Economics which went into great detail on the administration's tax cut proposal.

Mr. WALKER. Yes; but this is one of the fundamental questions. I mean if higher income individuals save more, that argues for one kind of approach. If everybody saves the same, that argues for another kind of approach. I'll have to look at the evidence in order to be convinced that indeed you have a higher marginal as opposed to higher average savings rate among upper income individuals. I'll pull that together and submit it.

Mr. GRACE. Senator, one of the things that may prevent the upper income people from saving more has been the fact that after tax returns—after capital gains taxes—on risky investment have been very low. They were in the red last year as my charts show and even if you cut the capital gains rate to 20 percent, it will only be 3.8 percent a year versus 11 in the 1950's and 1960's.

And, I think if you want to have a high savings rate in the upper income brackets since they think in terms of risk capital, then we have to do something about the capital gains tax.

Senator BRADLEY. I am all for reducing the capital gains. So, let's not argue that point, but it's just the backup analysis, because one of the things that troubles me is that you talk about bracket creep and social security and that affects one income class much more than another income class.

Then the question is who do you give the tax cut to. And who benefits the most from that tax cut. And, that goes directly to your assumption about what income class saves the most. So what I'm curious about is if the upper income groups save more does this justify skewing your tax cut toward these groups. Is that correct?

Mr. WALKER. In terms of the economic impact, yes. And in that testimony last week from Merrill Lynch on page 3, they say there's ample evidence that savings propensities increase significantly from lower to higher income brackets, which supports the Reagan tax cut approach.

A 1971 study estimated short- and long-run marginal savings propensities by income bracket based on a BLS survey. The Merrill Lynch statement details these findings on the testimony last week. And I will see if there is other evidence to that effect.

Senator BRADLEY. Let me ask you if you were going to cut the corporate rate as Professor Thurow suggested, instead of reducing depreciation, what would the amount of money that it's going to cost to implement 10-5-3 or some other kind of program, allow you to cut the two corporate rate to.

Mr. MASSA. You could cut it, I think, Senator, by the time 10-5-3 is fully phased in, you could cut it some 20 to 25 percentage points off the top.

Senator BRADLEY. From 46 to 25.

Mr. MASSA. At current rates. Now, I think you would have a lesser cut 4 or 5 years out. I think the latest figures I've seen from the Joint Committee on Taxation's staff suggests that per point the corporate income tax will be raising about $3 billion a point in the next 3 or 4 years.

If that is correct, then the equivalent dollar—the equivalent percentage points would be less than——

Senator BRADLEY. $3 billion a point.
Mr. MASSA. I think.
Senator BRADLEY. And what is your estimate of 10-5-3 revenue loss by 1985, 86.
Mr. MASSA. I believe that the revenue estimates are about $50 to $55 billion on a calendar year basis, I believe.
Mr. WALKER. Let me make two important points there. When Senator Bentsen started exploring depreciation reform in 1978, as a substitute for reducing the corporate tax, he made the point, that when you increase depreciation write-offs you get the biggest bang for the buck, in terms of investment and productivity, because you don't get the tax cut unless you buy the machinery and equipment. Second, the extent of the revenue loss in a sense, shows that you're getting a lot more investment. The larger the revenue loss, the greater the investment in productive plant and equipment. That's the bang for the buck.

I do agree with Professor Thurow on this. He said he would like to see our investment rate rise to 13 percent of gross national product. The rate had been around 10 or 11 percent. I think we need a higher rate badly now. How much investment? I kind of agree with what Mark Twain said about good bourbon whiskey. Too much is barely enough.

Right now, "too much" investment is not "too much," given our productivity growth rates.

Senator BRADLEY. Do you also agree with Professor Thurow that if you have increased levels of investment without dramatically increased savings rate, that it's a recipe for much higher interest rates.

Mr. WALKER. Yes, that is true. That is why I agreed with Senator Packwood that you need a balance. If you're going to have a big increase in business investment stimulated by 10-5-3, you need a big increase in individual savings to help finance that investment. But I think an 8-percent savings rate would do it. We don't need the 20 percent they have in Japan.

Senator BRADLEY. Let me ask you, what is the rate of inflation or what is the discount rate that you would need to assume so that 10-5-3 doesn't result in a negative effective tax rate on certain classes of depreciable assets?

Mr. WALKER. A very sophisticated study to that effect has been done by Dr. Raboy who will be testifying this afternoon, and his basic inflation estimates are, I think, along the lines of—and you don't just take an inflation rate, you have to figure how much of a return on the assets you will get——

Senator BRADLEY. Say the average return is 6 percent.

Mr. WALKER. The average return is 6 percent, and then if you take an expected 10-percent-inflation rate, you would have a 16-percent discount rate. He has constructed various alternatives that show how this would turn out. And, he says for 10-5-3 in the 5-year category, it approximates expensing.

Senator BRADLEY. What is the——

Senator DURENBERGER. Bill, I think that does mean your time is up. I know your all—Charlie's on his third cigar, so I know this panel's been here a long time. [Laughter.]

I want to apologize for not being here when the railroad train went by the picket fence, but with another hat on, I'm chairman of the Subcommittee on Intergovernmental Relations, and I'd like to ask a question that puts a somewhat different light on all this testimony we've been hearing this week and we'll be hearing in the next couple of weeks.

Charlie and Cliff, you sell your device in my State, and Mr. Grace has to put his feet to the earnings fire in my State, and I think you've got 10 or 12 small business enterprises in that State, and I'm going to preface my question by telling you a little bit about 1 of the 50 States in this country.

We have a biennial budget in our State of about $8½ billion. Like many States our budget functions are simply financing local government functions directly as in education aid or indirectly through shared revenues or property tax relief, or we spend Federal money by matching and spending Federal revenues as in medicaid or passing them on as in the case of AFDC or social services.

The result is, unlike the Federal Government, where we claim that 60 percent of our budget function is uncontrolled, the States in this country are now at the point where maybe 90 to 95 percent of their budget functions are under control.

In 1979, the start of the Minnesota Legislative session, we had a surplus of $700 million, which after all the spending decisions got done we turned back to the people in the State of Minnesota in the form of property tax relief.

We then proceeded to index the second highest and in some categories the first highest State income tax in this country to 85 percent of the CPI.

We also substantially increased the zero bracket amount and some of the personal exemptions.

Two years later, 1981, the legislature came back, they cut approximately $1 billion out of that approximately $8½ or $9 billion budget request and they still were $503 million short, so they went home Saturday night about midnight having increased State taxes by $503 million.

All of which is to prove, in my opinion, that the legislative function in my State is no longer to sit around deciding how much tax money we can spread on the problems of the State, how much we can cut the taxes, and where we can share them with local governments, but finally I come from a State where the legislative function is to determine responsible spending and then match that with the tax increases that are necessary.

So, my question is simply this. If we in this country, are serious and particularly if our President is serious about devolving responsibility for the delivery of public services back to State and local government and if he were serious when he was a candidate by saying we are also going to devolve resources back to State and local government so that they can afford that responsibility for the delivery of public services, and if we believe that some permanency and some predictability in taxes in this country is essential to get out the inflationary psychology or to get out the underground economy, then I would like each of the three of you to tell me why in the world our first priority should not be to index that Federal

income tax and the related taxes in this country to some formula that would eliminate bracket creep from those taxes.

[Senator Dole back to chair.]

Mr. GRACE. I will answer that Senator. I think it is a first priority, but I didn't think it was saleable.

Mr. MASSA. Senator, my taxation committee members and board members have got views going in both directions. And, I am unfortunately gagged on the subject.

There are people who feel that that is in fact what the President's tax proposal does at least for 3 years. And, others who feel that indexing is more a surrender than an attack on the problem.

I simply can't give you any constructive comment.

Senator DURENBERGER. They try to point to Brazil the way they do with gasohol and tell you that there is comparability. Charlie——

Mr. WALKER. I would go immediately for indexation of capital gains because I think that's a different animal entirely. But, in terms of indexing individual income taxes, I would prefer first to take a real run at stopping inflation. The more you index, the more you reduce the will to stop inflation, and I think that's the name of this game.

If we don't stop inflation, well, the whole ballgame is practically over.

Senator DURENBERGER. Thank you very much.

The CHAIRMAN. Are there other questions?

Senator LONG. I would like to ask a question, Mr. Chairman. Might I suggest that if need be—that you can't do any better—that at least he didn't ask all the questions he wanted. I don't think any Senator is trying to filibuster the hearing. I recall the days when we did have Senators filibustering. I used to sit around until midnight with George Malone when he filibustered the trade bill, and just as long as he—and may I say that it wasn't all that much fun, but at least everybody had a chance to have their say and ask questions. And I hope that it won't be necessary to deny Senators the opportunity of asking questions.

The CHAIRMAN. Let me just say, Senator Long that we certainly don't have that in mind. I just don't want to be unfair to the later witnesses who are going to be here until 5 o'clock with one bedraggled Senator.

Senator LONG. If they don't get anybody here, you'll have two. I'll be here with you. I'll stick around. [Laughter.]

I want to ask this from Mr. Grace. I read your statement. At least, I read your ad in the newspaper, in the Washington Post, and then their response editorial to you. I think that was you that put that ad in there wasn't it. And then your response to them and then the running debate. And there's something to be said for both sides of the argument.

I sort of thought that you maybe had a little better argument, but I think that both sides missed a key point and that is that implicit in the debate about the percentage of tax cuts, would be the assumption that the existing system was equitable, well balanced, productive, and carefully crafted in the national interest.

Now, Mr. Greenspan testified before us previously. And, we were impressed by it, that really if you had just indexed the Tax Code,

what you would be achieving with this bill would be not really very much different from the 10-10-10. It would be pretty much the same thing.

It would seem to be that when we fail to have a system, rather it be the regulatory aspects of it or the tax aspects of it that is productive, and we have a system is actually going down so that each year we actually produce less than we did the year before, there's no way that you can provide people with a better standard of living, because there's a smaller pie to cut, and there's no way you can divide that buy where you're going to be able to serve more than 100 percent of what's on the platter.

Mr. GRACE. Right.

Senator LONG. Now, the thought occurs to me that the debate between you and the Washington Post tended to bypass the key problem and that is that we didn't have an equitable, well balanced, carefully crafted system that served the national interest to begin with.

At some point, you're going to have to take a look at what's wrong with your system. So, if you assume that you've got some points in there that are broken down and not working the way they're supposed to work, just in a uniform across the board tax cut, doesn't meet the crying needs in certain areas.

And, then that being the case, in the areas where the crying needs exist, it would seem to me that we ought to try to take care of some of those, even a head of the across-the-board tax cut. I just want to get your thought about that.

Mr. GRACE. Yes, Senator, the only thing I would like to say is, that the debate between the Washington Post and ourselves was over a specific problem, because they came out and said that the Reagan tax proposals were regressive and that they were not progressive.

Part of the problem is that people who know nothing about things are doing a lot of writing about them and using adjectives and adverbs and using class hatred and everything else to try to decide economic problems, and all we wanted to do was to prove to the reading public that the Washington Post and Tom Wicker of the New York Times didn't know what they were talking about when they said that the Reagan tax cut proposals were not progressive.

That was the whole argument, and they finally, more or less admitted that they were wrong.

Senator LONG. There is another point that did not appear in the running debate that has to do with the point I'm making here.

Most successful people who have built businesses as you have done or who are in a position to make large investment, the kind of people to whom Charls Walker here has made reference. Look at that tax law when you get ready to make that investment.

Against a 70-percent income tax, it is more attractive to make all kinds of investment which defer the gain into a future year——

Mr. GRACE. Absolutely.

Senator LONG. Then it is to make an investment that would produce a great deal for the economy. Now someone made the point, I forget who, but it makes no difference, it's the same point, that the system we have today makes it very attractive for a lot of

people to advertise and others to respond to the ads to invest their money in painting and in works of art and all they're doing is bidding them up.

Mr. GRACE. That's right.

Senator LONG. Or, it makes it worthwhile for somebody to invest his money bidding on property which is already overpriced; and you say that's right.

Mr. GRACE. Absolutely.

Senator LONG. Or for that matter one of the most attractive ways one can invest his money if he is in the 70-percent tax bracket, and those are the people who are in the position to start a new business, and put people to work. It's one of the most attractive investments they can make. Is to invest their money in tax exempt bonds.

Because what they save against taxes with the interest expense that they have incurred in other respects, and I know we're supposed to try to get at that, but the law fails to do it. It gets down to being what my professor of criminal law taught me. It's not what you do, it's the way that you do it, that gets you by.

So, that you can find ways even when you have an interest expense to invest in a tax exempt bond and if you do it the right way, so that you still get your deduction for interest expense, it's a far better investment and far safer to put your money there rather than to put your money into starting a new business enterprise, that will put a lot of people to work and expand the gross national product; is that correct.

Mr. GRACE. Absolutely, Senator.

Senator LONG. So, that when you look at what our problem is, we have an outdated tax system. It's in such bad shape that we'd really do well to consider chucking the whole thing and getting ourselves a new piece of equipment. Just a whole new tax system.

And, then for us to talk in terms of saying well, now, hold on just a second. If we're going to do this, we're going to have to see to it that this guy gets the same tax break as that guy was all perceived on the assumption that you've got a good system to begin with. It means that the whole thing is based on erroneous assumption. Mainly, that you've got a good tax system. And, we'd do better to get at some of the big defects and some of the crying need while we're trying to make this thing work better.

Now, when we talk about cutting that 70-percent tax bracket, again you're assuming somebody's going to pay that 70 percent. He has the option. And most successful businessmen, let's talk about people who have made enough money already this year to where they're in a 70-percent tax bracket. Now those are the kind of people who could start a new business, and they could really do things to move this economy.

Most of them are going to make their investment for the remainder of this year in such a fashion that although in the long run they'll make some money out of all that, that that investment will gain them a net short-term—I mean a net short-term tax savings for this year. Is that not correct.

Mr. GRACE. Absolutely correct. Any intelligent person does not pay a 70-percent income tax.

Senator LONG. Confronted with that, he's got to look around and see what else is available. Here you are in a situation that if you put your capital to use in the way that would be most productive in the national interest. Both put more people to work, buy new equipment and whatever.

If you proceed to do all that, the Government's going to take 70 percent of that, and you can look at a tax-exempt bond which does not involve near the risk, but you'll pay no tax on that.

So, assuming that they would yield you, let's say, 12 percent. Is that fair Mr. Walker, you used to be an Under Secretary of Treasury. Is that about what taxes it will get you nowadays.

Mr. WALKER. No, Senator; 10 to 11 percent.

Senator LONG. All right, let's say 11 percent.

Mr. GRACE. At the most 11 percent.

Senator LONG. All right, well, make it 10, but even so 10 percent against a 70-percent tax rate compared to earning ordinary income——

Mr. GRACE. That's 32 percent.

Senator LONG. That's like 32 percent in the other situation. Now, furthermore—in a great number of cases, we are taxing earned income at 70 percent.

Mr. GRACE. Oh, absolutely, with the piggybacking.

Senator LONG. You understand what I'm talking about.

Mr. GRACE. I sure do.

Senator LONG. In other words, it's because of what the Tax Committee staff calls the stocking order. In other words if you start out and you have enough investment income, let's say it's something you might have inherited, so that you start out from zero and go up to 70 percent. So you're in the 70-percent bracket.

Now you go to work to make yourself useful, as well as owning a medal, and when you do that, every dollar you earn pushes that investment income up into a higher bracket. So every dollar you make, pushes another dollar up into the 70-percent bracket.

So, you are being taxed 70 percent on every dollar you make from that point forward. Is that correct?

Mr. GRACE. It is, Senator.

Senator LONG. It wasn't right, and I didn't want it that way, and if I had understood it was going to be that way, I would try to keep it from happening. I was around when this thing happened.

And, people would say, well why did you treat us that way. It's all we could do at that time to get you the 50-percent limit on the earned income. To get to save anything for you at all in what was a disaster around 1969 when the House tried to do something about it. They tried to limit us to 50 percent. Some of our former friends over in the House took out everything over there that would help a corporation, and by the time our friends in the Senate got through, they took out everything that would help anybody, except the low income taxpayers by spending the personal exemption, and all we could save out of that conference was that 50 percent on earned income.

You're familiar with that, aren't you, Mr. Walker? You were around here at that time.

Mr. WALKER. I was in that Conference.

Mr. LONG. And, there was a pretty dismal achievement by one who started out by saying that 50 percent ought to be the most you pay on what you earned. Is that about the way you would call it.

Mr. WALKER. Yes, sir. It was tough to get that.

Senator LONG. So, here we are now, that was about 1969 wasn't it, and here we are about 1980 still talking about doing something that the administration recommended back in 1968 or 1969.

It is counterproductive to tax people at 70 percent. All sorts of things that need being done, are simply not going to be done against that kind of a disincentive.

Mr. GRACE. Yes; and furthermore, Senator, they are the most imaginative, creative people, and they have the least to risk, but they'll take the biggest risk if they have an incentive such as a very low capital gains tax, and not this very high 70-percent incremental tax.

These are the people that have made their money by taking risks. If they have money they'll do all kinds of things. But they can't save money this way.

Senator LONG. Well, all of that leads me to the conclusion that regardless of how we work out the details from what we have here, we ought to add to the bill or a bill—and I'm afraid to wait for a second bill, for fear that it might run aground before it goes through. I just think that it would cost so little in terms of revenue to do it, that we ought to add to this bill.

What we did in 1978 when the Senate voted, voted about 90 to 10 after we heard some of the most eloquent speeches that rang the rafters about how inequitable it was when we voted to say that by a 90- to 10-margin, I believe, to say that you only tax 30 percent of your capital gains.

Now, that provides a real incentive for a businessman to start a business, build a business up and at least at some point, he can come out—it would work out to about 15 percent.

Mr. GRACE. And that paid off, Senator—big. I mean the latest data show that it paid off big. That's one of the most constructive things that's been done in the last decade.

Senator LONG. Now, I want to ask Mr. Walker, how much do you think it would cost the Treasury for us to do that.

Mr. WALKER. It wouldn't cost a cent. Their capital gains receipts went up $1.8 billion the next year. The biggest increase in history, and a big hunk of that came from very high income people. I think it more than paid for itself.

Senator LONG. Thank you.

Thank you very much, Mr. Chairman. I appreciate it.

The CHAIRMAN. I think you have made a strong case for the Reagan program. I appreciate it. [Laughter.]

Senator LONG. With a small add on. [Laughter.]

The CHAIRMAN. That's one add on we agree on.

Are there any other questions of this panel? We have eight panels left. Senator Danforth.

Senator DANFORTH. No questions.

The CHAIRMAN. I missed some of the responses, but I think I'll forego any questions. I appreciate very much the response from the panel.

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I do believe that there can be some agreement reached with the administration and those who have somewhat similar views, perhaps not those who have totally opposing views.

Did anyone comment on less than 3 years?

Mr. WALKER. No.

[The statements of the preceding panel follow:]

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

Mr. Chairmen and Members of the Committee, my name is Charls E. Walker. I am volunteer chairman of the American Council for Capital Formation. I appreciate the opportunity to present the views of the American Council on the tax reduction proposals in the Administration's Program for Economic Recovery.

The American Council for Capital Formation is an association of individuals, businesses, and associations united in their support of legislation to eliminate the tax bias against saving and productive investment. Our members, individuals as well as business, support legislative measures which are designed to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force.

The American Council strongly supports the Administration's tax proposals—both its individual marginal rate reductions and its accelerated capital cost recovery system. We also endorse the Administration's multi-year approach to tax cuts. However, if Congress, in its wisdom, decides to alter the Administration's program of tax cuts, we urge that any modification meet certain standards for sound saving and investment tax measures.

OUR ECONOMIC DILEMMA

The nations of the world have long looked to the U.S. for economic and industrial leadership. Yet, in the last two decades, U.S. economic growth, investment, productivity, and savings rates have slowed relative to our world competitors. According to a recent study (November 1980) published by the McGraw-Hill Economics Department, the U.S. produced 26.5 percent of the world's output in 1960. By 1978, however, the U.S. share had declined to 21.8 percent.

The statistics for investment in plant, equipment, and housing are equally discouraging. The McGraw-Hill study of six major industrialized countries indicated that other countries, such as Japan, devote a much greater proportion of their resources to investment. For example, in 1978, Japan had twice the investment as a percent of GNP (32.8 percent) as the U.S. (16.4 percent). France and Germany were not far behind, with slightly over one-fifth of their resources devoted to investment. Even Italy and the United Kingdom had higher proportions of investment to GNP than the U.S.

Productivity, or the amount of output per hour of work, grew at a meager 2.8 percent from 1960 to 1977 in the U.S., trailing behind the other industrialized countries surveyed in the study. Japan's performance was the strongest, with an annual average growth rate of 8.1 percent over the 17-year period, followed by France (5.6 percent), Germany (5.5 percent), and the United Kingdom (3.0 percent).

Moveover, recent figures comparing personal saving rates in eight industrialized countries show that the U.S. trails with a lower rate of saving than any of the other countries. In a recent study (February 1981) based on Commerce Department statistics, the New York Stock Exchange compared personal saving rates in eight countries on average from 1975 to 1979 and found that while our major industrialized competitors had rates of personal saving ranging from 21.5 percent (Japan) to 10.3 percent (Canada), the U.S. rate of personal saving trailed with a meager 6.3 percent over the same time period. In addition, a look at savings trends in other industrialized countries shows that while most other countries have enjoyed a general upward trend in the pattern of personal saving rates over the past decade, the U.S. rate has fallen sharply since the mid-1970's.

An economy's ability to invest in new plant and equipment, and thus to grow, depends on its saving rate. Savings, both personal and business, provide the resources for investment. Yet, to the extent that income from saving and investment is taxed, the incentives to save and invest are eroded—underscoring the need for productive tax reform.

INDIVIDUAL MARGINAL TAX RATE CUTS

President Reagan has asked this Congress to enact across-the-board proportionate cuts in individual marginal tax rates adding up to 30 percent over the next three years. Current highly progressive marginal tax rates range from 14 to 70 percent; under the President's proposal, they would range from 10 to 50 percent.

The American Council strongly supports the so-called "10-10-10" individual tax rate cut concept as embodied in the President's tax package. It is a bold measure which would powerfully increase individual incentives to work, save, and invest. It has generated widespread debate and controversy in the Congress and the press.

The 10-10-10 proposal is viewed by many as a massive reduction in the tax burden on individuals and, since individuals are also consumers, it is reasoned that most of the reduction will be spent on consumption, thus adding a great amount of fuel to the fires of inflation. This is a very distorted picture.

The first point to note is that 10-10-10 is a reduction in tax rates which, unless inflation slows much faster than anyone expects, would only slow the growth in the Federal tax burden. Those people who argue that 10-10-10 should be scaled back in order to assure an earlier balance in the Federal budget are in effect calling for balancing the budget on the backs of middle-income taxpayers.

The economics of the matter aside, this is, in may view, unwise both politically and socially. Indeed, the passing case for 10-10-10 as a reduction in the tax load on the group that provides political and social stability in our country has received insufficient attention. Now battered by the steep marginal rates that were a product of tax philosophy in war and depression, more and more middle-income Americans are seeking tax shelters in the form of at least some tentative entry into the "underground economy." The ultimate danger to our individual income tax system of expansion of this type of tax evasion needs no elaboration before this Committee.

The second point to note is that any tendency of 10-10-10 to swell the Federal deficit would be reduced by the budget cuts now moving through the Congress. In fiscal 1982, the budget and tax cut proposals are in the same ball park. The Administration has promised additional cuts in later years and, in fact, only last week proposed changes in the Social Security system which will both assure the viability of that system and reduce growth in future outlays.

The third point has to do with the impact of the reduction in rates on taxpayers' decisions to spend, save, and invest. In this respect, 10-10-10 has been given a bum rap. Critics argue that both experience and logic point to an inflationary surge in spending; the fact is that both point in the opposite direction, toward a substantial increase in saving.

In this respect, consider the major beneficiaries of the cut in tax rates. It is middle-income taxpayers, defined not in the statistician's image of $20,000 per year in median family income, but in its own image, which perhaps covers a range of $15,000 to $50,000 a year. These families pay 65 percent of all Federal individual income taxes and would receive 67 percent of the tax cut. These are families which save, with the amount of savings rising sharply as you move up the income range. They are the people who hold hundreds of millions of dollars in savings in banks, savings and loan associations, credit unions, savings bonds, money market funds, and other forms. It is ridiculous to say that these thrifty middle-income Americans are going to devote all or most of any tax reduction to spending on consumption.

In fact, both logic and experience suggest that the individual savings rate should increase. Although any rise in disposable income will be reduced in real terms by continued inflation, that increase will surely be greater than if no tax rate reduction were voted by Congress. In addition, the cut in marginal tax rates would significantly increase the incentive to save and invest. For the family with $30,000 in taxable income, the marginal tax rates would drop over the three years from 37 percent to 27 percent.

Tax rate reductions of the type proposed by President Reagan have in fact been tested. This was in 1964-65, when the Kennedy-Johnson supply-side individual tax reduction cut rates from 91 to 70 percent in the top bracket, from 20 to 14 percent in the bottom bracket, and more or less proportionately in the intermediate brackets. Between 1963 and 1967, the personal saving rate rose by almost 3 percentage points, from 5.4 to 8.1 percent. To be sure, inflation was moving more slowly at that time, and continued inflation will doubtless reduce middle-income families' ability to save in the months ahead. Still, the saving rate can be expected to rise.

This point is now a subject of hot debate among economists, but few people have bothered to ask taxpayers what they would do with any tax cuts. The Gallup organization did in August 1980, asking people what they would do with a 10 percent reduction in taxes, spend or save it? Forty-one percent said they would spend most of it; 40 percent said they would save most of it. But in fact that question was poorly worded, for few individuals realize that the act of saving is

really a negative act; it is the act of not spending on consumption. Therefore, debt repayment is saving. When Opinion Research Corporation asked people in March whether they would use most of any tax cut to spend on consumption or would save it, including repayment of debt, a whopping 82 percent pointed to the second alternative. This percentage is probably too high, but it does indicate the propensity toward saving on the part of individual Americans.

After surveying all of this evidence, I can only conclude that the 10-10-10 tax reduction would result in a significant increase in the personal saving rate. By how much? No one can say. But it is important to remember that, for every one percentage point increase in that rate, individual saving would rise by some $20 billion. This reponse would do much to finance any deficit through saving. And that, in turn, would make it much easier for the Federal Reserve authorities to promote an appropriate rate of monetary growth without exerting undue pressure on credit markets.

The final point to note about 10-10-10 is the charge by some that it is a Fat Cat tax cut—people with high incomes would get much larger reductions than people with low incomes. What this means, of course, is that taxes will have been cut in proportion to the way people are paying them now. What's unfair about that? It is not unfair at all and in fact should disturb only those who want to further increase the progressivity of an already overly progressive individual income tax system in order to redistribute income through that tax system.

TARGETED INDIVIDUAL SAVINGS PROPOSALS

Another approach to meeting the twin goals of reducing the middle class tax burden and encouraging saving and investment would be a partial substitution of carefully targeted individual saving incentives for some portion of the marginal rate cuts.

In testimony before your Subcommittee on Savings, Pensions, and Investment Policy on May 4, I suggested that any targeted saving incentives should satisfy three criteria: First, such proposals should stimulate additional savings, not simply shift funds. Second, such proposals should meet the standard of simplicity. Third, such proposals should be evaluated in terms of their revenue impact because some saving proposals are more cost effective than others.

Four specific saving and investment proposals meet these tests and should be given serious consideration.

First, the American Council supports a reduction in capital gains taxes through increases in the capital gains exclusion. Under the Administration's marginal tax cut proposal the top rate on capital gains would be reduced from 28 percent under current law to 26.4 percent in 1981, 24.0 percent in 1982, 21.2 percent in 1983, and 20.0 percent in 1984.

On the other hand, increases in the capital gains exclusion would provide for an up-front cut in the existing capital gains tax rate, thereby avoiding the potential capital gain "lock-in" that might be associated with gradual reductions in marginal rates.

There are two proposals to lower the tax on capital gains through the exclusion approach. S. 75, sponsored by Senators Wallop and Moynihan, would increase the excludable portion of capital gains from 60 to 75 percent and would reduce the top capital gains rate for individuals from 28 percent under the present law to 17.5 percent. It also would reduce the capital gains tax rate for corporations from 28 percent under present law to 17.5 percent. S. 145, sponsored by Senator Moynihan, would increase the excludable portion of capital gains from 60 to 70 percent and would include a reduction in the top marginal tax rate for individuals from 70 percent to 67 percent, thereby reducing the top capital gains rate for individuals from 28 percent under present law to 20.1 percent. It also would reduce the corporate capital gains rate from 28 percent to 20 percent.

These proposals should be evaluated within the context of the impact of the 1978 capital gains tax cut. Put simply—it worked, and it worked very well indeed. First, it encouraged an increase in corporate stock ownership. Second,it had a significant effect on the new issues market for firms going public for the first time. Third, it resulted in a substantial increase in commitments to venture capital funds; the funds needed to put innovative business idea into a working reality. Finally, the latest Treasury estimates show that instead of being a revenue drain, the taxes paid on the capital gains income of individuals in 1979 acutally rose from $8.3 billion to $10.1 billion, an increase of $1.8 billion—the largest absolute gain in the history of the tax.

Second, the American Council supports an immediate reduction in the maximum tax on so-called "unearned" income from 170 percent under present law to 50 percent, thus equalizing the maximum tax on wage and salary income, and saving

and investment income. The proposal also would immediately lower the top individual rate on capital gains from 28 percent under present law to 20 percent, rather than in stages, as under the Administration's marginal rate cuts. The top capital gains rate under this approach would be reduced from 28 percent under present law to 20 percent.

Third, the American Council supports S. 936, sponsored by Senators Roth and Bentsen, which would decouple "earned" and so-called "unearned" income for tax purposes by taxing each type of income separately at rate schedules ranging from 14 percent to 50 percent. Under this proposal, the first dollar of "unearned" income would be taxed at the lowest bracket rate, rather than at the highest rate after earned income. The Roth-Bentsen approach would lower the top tax on capital gains from 28 percent under present law to 20 percent.

Fourth, Harvard Professor Martin Feldstein, President of the National Bureau of Economic Research, has suggested a percentage exclusion for interest and dividend income. This approach would treat dividend and interest income in the same manner as capital gains income, and would provide for a powerful savings incentive effect. By applying to each additional dollar of interest and dividend income, the Feldstein approach would lower the tax on saving at the margin where it would be most effective in raising aggregate levels of saving. This approach would also ease the double taxation of dividends. The Feldstein approach is embodied in several proposals, including S. 155 introduced by Senator Schmitt, which would make permanent the existing exclusion for certain interest and dividend to $200 ($400 for joint returns) plus 25 percent of additional interest and dividends up to $50,000, phased-in over five years.

DEPRECIATION REFORM

President Reagan has also asked Congress to enact the Accelerated Cost Recovery System (ARCR)—a refinement of the well-known and widely supported "10-5-3" proposal for faster and simpler recovery of investment costs.

Fortunately, there is today wide agreement that simplification and liberalization of the tax treatment of business depreciation stands in the highest order of priority among tax legislative actions. The strongest and broadest support has been provided for the Capital Cost Recovery Act (CCRA), also known as 10-5-3. An alternative measure by Senator Bentsen, which provided four class lives (2-4-7-10) for equipment and two (15-20) for structures, was approved unanimously by this Committee in its ground-breaking tax cut bill last summer.

The question before the Congress is not whether our outmoded depreciation system should be reformed but how.

To put the "how" in the proper framework, it is useful to review the current consensus behind the need for depreciation reform; the 10-5-3 proposal; and the objectives of depreciation reform which we believe can best be accomplished through 10-5-3.

First, the consensus regarding the need to take action to reform tax depreciation practices has emerged after several years of thoughtful study and discussion of the problems facing American industry. As early as 1978, former Treasury Secretary G. Willian Miller (then Chairman of the Federal Reserve Board) stated before this Committee, during its consideration of the Revenue Act of 1978: "Faster depreciation is likely to yield the greatest addition to investment per dollar of tax reduction." He added then that he ". . . would like to see us work over a number of years to a point where the depreciation life for machinery and equipment would be five years. . . . and a ten-year write-off for structures.

Today, the Reagan Administration, most Members of Congress, and most major business associations support the 10-5-3 concept as the best approach to depreciation reform. Why has this consensus arisen? Because the 10-5-3 concept is the proposal before Congress that best meets the three standards that should guide the evaluation of a capital cost recovery proposal.

First, such a proposal should provide some protection against the erosion of capital caused by inflation.

Second, such a proposal should speed up and improve the overall rate of capital recovery in order to encourage investment while moving away from the "useful life" concept.

Third, such a proposal should be easy to understand, simple for taxpayers to apply and Treasury to administer, and available to all businesses, both large and small.

The 10-5-3 concept embodied in the Administration's Accelerated Cost Recovery System would best meet these guidelines. It would provide a reasonable offset for a range of inflation rates, provide incentives to invest in capital assets, minimize the "useful life" concept, and meet the standard of simplicity.

Much attention has been devoted in Congress and the press to a new approach to depreciation, the First Year Cost Recovery System (FYCR) developed by Harvard Professors Dale Jorgenson and Alan Auerbach. In my testimony before this Committee last summer, I criticized this proposal because it contemplated repeal of the investment tax credit and also would result in even higher tax rates on important types of business equipment. Responding to that criticism, Professor Jorgenson has modified the system to include MIT Professor Cary Brown's "neutral tax credit" and thus avoid the effective tax rate increases inherent in the original proposal.

Under this new version of FYCR, Treasury would project so-called economic useful lives for 35 different classes of depreciable property. Based on that projection, a future stream of depreciation deductions would be calculated. Then, the discounted present value of that future stream of deductions would be determined using an after-tax discount rate of 6.06 percent. That discounted present value, termed the First Year Allowance, would be allowed as a deduction in the first year. No further deductions would be allowed, but the First Year Allowance would be combined with a variable investment tax credit designed to produce whatever effective tax rate is desired—anywhere from zero (equivalent to expensing) to the statutory rate of 46 percent.

Supporters of FYCR claim that the system is simple to apply and easy to understand, is less expensive than other proposals and, in contrast to 10-5-3, will not result in negative tax rates. Under analysis, these claims fail to stand.

Consider, first, simplicity for the taxpayer. FYCR is easy to apply; taxpayers could simply refer to a table. The same could also be true of 10-5-3. Taxpayer understanding of the mechanics of the two systems is something else again. Although 10-5-3 needs little explanation, the FYCR blending of First Year Allowances and some 35 different investment tax credits can only confuse the typical taxpayer. The retention of 35 useful life categories in itself violates a basic principle that 10-5-3 would honor. In addition, the application of the 35 different investment tax credits that are now part of the modified proposal can only cause further confusion.

Take the case of a farmer who purchases for his business some furniture, a tractor, a truck, and an auto. The First Year Allowance on the furniture is 0.645; on the tractor, 0.729; on the truck, 0.807; and on the automobile, 0.846. This is not all. Under FYCR, each of these allowances is combined with a different investment tax credit. Is the local merchant expected to explain to the farmer what "discounting" means and why the First Year Allowance varies so much? Or why each of the assets is subject to a different investment tax credit? For businessmen who are accustomed to thinking in terms of a flat 10 percent credit, off the top, the concept of some 35 different ones is likely to cause confusion if not consternation.

This confusion might just possibly be overcome if much time and effort were devoted to explaining this overly complicated system. What cannot be overcome is the tremendous administrative authority the approach would place in Treasury. A discount rate has to be selected, and the precise level of that rate will affect many billions of dollars in depreciation allowances. As is noted below, the discount rate used by Jorgenson has been criticized as inappropriate. Even if its basic characteristics could be agreed upon, its selection by Congress would incur serious drawbacks; what should be an economic decision would doubtless become entangled with political considerations. And that trouble would recur any time the rate needed to be adjusted.

Consequently, the only practicable approach would be for Congress to delegate the selection and settling of the discount rate to Treasury, but that in turn would vastly increase the administrative power of that Department (power that is already great because of decisions as to class lives). A discount rate on the low side would increase the present value of the stream of earnings on the asset, which would in turn raise the First Year Allowances and vice versa.

Proponents of FYCR who argue that it is less expensive than other approaches are wrong. FYCR in effect says nothing about revenues; it is neutral. The discount rate, First Year Allowance, and investment tax credits can be set at levels that will gain Treasury revenues, break even, or lose large amounts.

If FYCR is to be preferred, it is not because it is less expensive than 10-5-3. As to revenues lost, it should be remembered that the goal of depreciation reform is to foster capital formation. To the extent this is the case, the relatively large revenue losses that static forecasts attribute to 10-5-3 in effect mean that a lot more productive investment is taking place. Critics should, therefore, argue that the investment stream itself will be too large, not the revenue impact. I have seen no critiques that take this approach.

Does 10-5-3 result in negative tax rates? Professor Jorgenson so charged in recent testimony before the House Ways and Means Committee. But the study on which the charge was based assumed an unrealistically low discount rate based on yields

on a range of U.S. government securities, the lowest risk debt assets available. This assumed discount rate is crucial to the computation of effective tax rates, which is a highly theoretical exercise at best. Noting that there is no theoretical justification for constructing a discount rate in this manner, David Raboy, Director of Research for the Institute for Research on the Economics of Taxation, has constructed a discount rate in a more proper fashion, i.e., by adding a factor representing expectations concerning future inflation to the real after-tax return on physical capital. His conclusion: over a plausible range of inflation rates, the 5-year category (the heart of 10-5-3), involves no negative income tax but instead approximates "expensing," i.e., immediate write-off of capital assets.

Clearly, reform of the U.S. capital cost recovery system is long overdue. Such reform would afford significant dividends in terms of capital formation and at the least "cost" in terms of foregone revenues to the Federal government. This is because a business would enjoy a tax reduction from accelerated depreciation only if the requisite investment had been made in the first place.

The most recent statistics show that total investment is high by historical standards but this magnitude is illusory, caused by inflation. Accelerating prices and interest rates and shifting economic policies have helped to create a climate of uncertainty and have contributed to the unwillingness of American business to make long-lived investments. As a result, our stock of productive plant and equipment depreciates faster, so that more investment is needed simply to stand still.

In short, the American Council for Capital Formation strongly supports ACRS, as proposed by the Administration, as the best cost recovery proposal on the table. One change, however, should be made to bring the ACRS proposal back into line with the original 10-5-3 proposal.

At issue is the necessity for "flexibility" in the use of each year's capital recovery allowance. The ACRS requires that each taxpayer use the maximum allowable deduction each year. However, a taxpayer's ability to spread deductions over a long period of years allows for much greater certainty when assessing the economic efficiency of an investment. During periods of low profitability a business may not be able to take the maximum allowance. Thus, the ability to have discretion in the forward use of deductions would greatly enhance the economic viability of the ACRS.

CONCLUSION

This Committee has a tremendous opportunity and challenge before it. Our current Federal income tax system is a product of the social and economic views of the 1930's with its emphasis on income redistribution and bias in favor of consumption. The challenge today is to change the focus of our system to reward work, saving, and investment. The Senate Finance Committee showed its willingness to tackle this task in crafting a consensus, pro-capital formation tax package last summer. This year you can do even better, and I am sure you will do so in the months ahead.

TESTIMONY OF

CLIFF MASSA III

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

May 19, 1981

"The President's Tax Program"

My name is Cliff Massa III, and I am Vice President of Taxation & Fiscal Policy for the National Association of Manufacturers. The following summarizes our comments and recommendations on the President's overall economic program, with particular emphasis on tax issues.

- The NAM supports the President's "Program for Economic Recovery" as a major and necessary change in the direction of national economic policy. We support the overall program for spending reductions even though specific cuts will have adverse effects on particular industries and firms.

- The NAM urges prompt action by this Committee to approve the tax reduction proposal of multi-year marginal rate reductions for individuals and the 10-5-3 capital recovery allowance system, the latter with an effective date of January 1.

- The NAM urges restraint in considering other tax initiatives. While we support many other proposals affecting both corporate and individual taxpayers, it is our recommendation that these issues be considered only after the marginal rate and capital recovery proposals are adopted.

THE PRESIDENT'S PROGRAM

The President's "Program for Economic Recovery" outlines a major and necessary change in direction for this nation's economic policy. The four points affecting federal spending, taxation, regulation and monetary policy are designed to create quickly a climate in which economic growth and improved productivity can be generated and sustained. The long-term results should be a substantial reduction in inflation along with an improved standard of living for Americans.

The National Association of Manufacturers supports the program as a package. The elements are all important to the change in economic direction. We are devoting major resources to working with the Congress to enact all of the elements expeditiously.

Spending Reductions

We communicated to both the Senate and the House that NAM considers the overall level of proposed spending reductions to be desirable and that this figure should be generally accepted before specific program cuts are analyzed. Recent conference committee action on the first concurrent budget resolution appears to have completed the essential first step. Now, we urge the various committees to make the tough decisions on program cuts to implement the resolution.

We want to congratulate the Finance Committee on your recent actions to implement spending cuts. We hope that your colleagues on other committees will be equally as effective in their work.

Our support for such cuts is unconditional; we are not carving out any untouchable areas. Our Board of Directors has expressly stated NAM's support for a broad based package even though it includes spending cuts affecting business in general and some of our members in particular because we recognize the need to share the cost of reduced federal programs. Business leaders, including NAM executives, have talked a great deal over the years about cutting the budget. Now we are putting legislative effort into what has previously been primarily a rhetorical posture.

MARGINAL TAX RATE REDUCTIONS

As a capital retention mechanism, the 10-5-3 capital recovery allowance system is a crucial element in a program to revitalize American industry, and this statement will discuss that issue in detail later. Yet it is individuals who are the major sources of new capital for both the new business and the growing business. In order to assure adequate capital formation, venture capital investment and real economic growth, the prime objective of long-term tax policy should be a moderation in rates of tax on such taxpayers as well as on corporations.

Therefore, NAM supports the President's proposed across-the-board marginal tax rate reductions. In our view, such reductions are needed:

- to reduce the rate of taxation on income from all forms of savings and investment such as capital gains, dividends and interest, thereby reducing the double taxation of savings and investment and enhancing their appeal;
- to reduce the attractiveness of artificial ventures designed to shelter income, thereby making productive ventures more appealing;
- to reduce the appeal of tax-free benefits as compensation and of the underground economy, thereby allowing the time and talents of those affected to be devoted to productive endeavors; and
- to reduce the rate of taxation on millions of small businesses that, as sole proprietorships or partnerships, are taxed under the individual tax rates.

The Need for Marginal Rate Reductions

With its graduated rates, the individual income tax imposes an increasingly greater real tax burden on additional income from either work or savings. Increments of as little as $2,000 to $4,000 can move taxpayers into brackets that impose a marginal rate--i.e., a rate on each additional dollar--that is 3 or 4 percentage points higher than the marginal rate in their current bracket. If such incremental income is merely an offset to inflation, the taxpayer will experience a decrease in real income beause tax liability will go up while real income will not.

As taxpayers move into higher brackets, the ever increasing marginal tax rates become serious problems. Taxpayers are less and less inclined to subject themselves to such rates. For those who reach their limit of tolerance, the result is either:

(1) a disincentive to work more or to invest more because the resulting income is taxed too heavily; or

(2) the creation of ingenious plans to avoid paying higher rates through non-taxable benefits or tax shelters or to evade such taxes through the underground economy.

Taxpayers' behavior is most strongly influenced by what happens at the margin of their economic activity. In other words, a decision to change work and leisure habits or to revise consumption and savings patterns can be influenced most strongly by focusing on the next increment of dollars with which the taxpayer can make a choice.

Is it worth it for the employee to work overtime or to seek a promotion or for the independent worker to accept more jobs or more contracts? Is the tax bite so large that the value of leisure time is greater than the value of taxable work time?

Is it worth foregoing a new car or a vacation or extra entertainment or weekly steaks in order to put money into a savings account or corporate stock or the family business so that one can buy more things in the future? Is current consumption cheaper than diverting funds to taxable investment?

The current system of graduated rates tends to make taxable activities, such as working and investing, less and less attractive as income rises because additional income is taxed at higher and higher rates. For many middle and upper income taxpayers--including individual investors, small business owners and workers--the decision has been made to follow one of the two paths noted above. Either way, the economy is the loser.

The question being asked by public officials and by business executives in firms of all sizes is what approach to take to stop and then reverse this trend.

Savings Proposals

There are numerous proposals affecting savings and investment that are intended to address this problem. At various times, NAM has urged consideration of most of them--an increased capital gains exclusion, tax-deferred rollover for capital gains and investment income, higher interest and dividend exclusions, repeal of the 70% maximum tax on so-called "unearned income," expanded IRA's, integration of corporate and individual tax structures, dividend reinvestment plans and so on. Most of these have at least some merit and seek to address a current problem, although they present varying degrees of economic efficiency.

Marginal Rate Reductions

However, NAM supports the President's proposed across-the-board marginal rate reductions as the most efficient, evenhanded and reliable means to accomplish the objectives that we seek in the areas of individual tax reductions affecting savings and investment. The President's recommendation for a 3-year, 30% reduction is an appropriate target. Our Board of Directors has unanimously resolved that NAM work for its achievement.

Our support is based on the following conclusions.

General savings incentive. Marginal rate reductions lower the cost of all forms of savings relative to consumption. Taxes on capital gains are cut as the general rates are lowered, along with taxes on interest and dividends and on earnings of non-corporate businesses. This reduces the cost of investing in growth companies,

in mature dividend-paying companies, in one's own small business, in a savings account that helps to finance local businesses and home-building and in other activities. These across-the-board results are achieved without the need to enact a series of more targeted proposals to affect particular forms of savings and types of investors. Even the enactment of a series of such proposals creates a potential for artificial allocations of savings and investments by overlooking some areas while highlighting others. Rate reductions create the maximum flexibility for the individual to choose the desired form of savings without a tax-induced decision favoring one particular form.

Attack on artificial investments. The perennial discussion of tax shelter investments concerns industry as well as the Congress and IRS because it highlights the level of investment in artificial ventures that are, therefore, not invested in productive enterprises. But efforts to attack the specific mechanisms overlook the cause of such devices--namely, the high tax rates that people seek to avoid.

It should be noted that such devices are no longer being marketed only to those people who are already in the 60% and 70% marginal brackets. If you read the financial advertisements in major newspapers and watch those mailings from investment brokers, you will see a strong pitch being made to taxpayers who are reaching the 40% and 50% brackets on their wages and salaries. Such ventures are luring many upper middle class people away from productive ventures. No degree of congressional or IRS tightening of the rules is able to end the resourcefulness of talented advisors in these areas, and the reason is simple. The motivation to avoid high marginal rates is still strong enough to divert much time and money into devising ways to achieve that end.

Significant reductions in marginal rates will do much to destroy the reasons that artificial ventures are used. This will improve the prospects for larger investments in productive business entities.

Attack on the tax-free economy. In addition to tax shelter devices, high rates have created strong pressures for non-taxable fringe benefits as compensation and an underground economy that is completely unreported. The desire to seek such untaxed income can be lessened by attacking the cause--high marginal rates. When less time and talent is devoted to beating the system, more can be devoted to working productively within the visible and taxable economy.

Direct benefits to small businesses. While NAM's members are almost all corporate, we are very much interested in rate reductions for the millions of sole proprietors and partnerships whose owners' business income is taxed under the individual rate schedules. Marginal rate reductions are a simple and direct tax cut for this major sector within our economy.

We recognize that there are doubts about the economics of marginal rate reductions. We also recognize that there are strong, well-founded arguments in favor of specific proposals affecting

savings and investment. In fact, we have made some of those arguments ourselves.

However, it is our considered judgment that an across-the-board reduction in marginal tax rates is the best approach to take as part of an overall economic program in 1981. We urge its adoption.

CAPITAL RECOVERY ALLOWANCES

NAM continues its strong commitment to the 10-5-3 capital recovery allowance legislation introduced this year as S. 287 by your Committee colleague, Senator John Heinz. So far this year, Senator Heinz has been joined by 46 cosponsors including several members of this Committee. During the 96th Congress, 10-5-3 was originally sponsored by four members of this Committee--Senator Packwood, Senator Chafee, Senator Bentsen and Senator Nelson--and was cosponsored by 53 members of the Senate. 10-5-3 now is the core of the administration's accelerated cost recovery system, known as ACRS. We are active participants in the very broad based coalition of organizations and firms that have supported 10-5-3 from the outset. Our support has not wavered during the last two years.

We believe that 10-5-3 is the business tax proposal that enjoys the widest and deepest support from firms and organizations around the country for many reasons:

- it will improve their own rates of recovery, thereby making viable a number of otherwise marginal or uneconomical investments;
- it will improve the rates of recovery for purchasers of their products, thereby creating long-term growth in their own markets;
- it will create a climate that encourages investment in newer and more productive assets, thereby stimulating increased levels of research and development in new technologies and more energy efficient processes; and
- it will help to stimulate revitalization of America's industrial base, thereby contributing both to the health of service and financial sectors that ultimately need a growing manufacturing community and to the readiness of our national defense capabilities.

Timing

We very strongly recommend that this be the first substantive issue addressed by the Committee when you begin mark-up sessions. The strong support for 10-5-3 within this Committee and in the Senate, backed by the administration and businesses all around the country, offers an opportunity for a swift agreement on both the effective

date, which we believe should be January 1, and the specifics, which we believe are already well outlined.

The importance of prompt action lies in the certainty that it can create and the resulting climate for investment planning. Prior to the announcement by the leadership of both congressional tax writing committees that depreciation changes will be effective no later than March 11, we were hearing of investment delays as business managers held out to the last possible moment in the hope that their new purchases would be covered. That announcement apparently has removed doubts for already planned investments. However, we continue to support January 1 as the effective date because of the number of firms that accepted--perhaps prematurely--the press and congressional speculation of last year and early this year that all investments in 1981 would be covered by the changes. A January 1 date does not appear to carry a major revenue cost, and it would prevent some potentially arbitrary results.

Prompt Committee approval of the details of 10-5-3 also would lend further credibility to congressional action and begin the lengthy process that is required to plan new investments not now judged economically viable. The longer the delay before a specific plan is adopted, the longer the period before net new investments will be seen.

The Concept

The details of 10-5-3 as embodied in S. 287 and ACRS are well known to this Committee. Rather than rehash these specifics, this statement will discuss the fundamental objectives of the proposal and respond to questions and comments that have been heard lately.

10-5-3 is the product of careful development; it did not spring fully grown from congressional sponsors' pens. The specifics as developed by the sponsors and their advisors were created over a period of several months with specific objectives in mind.

We believe that its two fundamental objectives are:

(1) to replace the useful life concept of depreciation with a system that allows uniform rapid rates of recovery, thereby reducing the cost of capital and promoting faster reinvestment while eliminating Treasury's administrative power to affect rates of recovery; and

(2) to create a simplified system that will place all types of businesses--large and small, corporate and non-corporate, industrial and distributive--under one simplified set of rules.

The Spread of Benefits

As conceived, 10-5-3 is a structural change that can encourage a long-term improvement in the investment climate. It is not intended to be--and should not be changed to become--an economic quick fix, a bailout mechanism or a reward.

Long lived assets. 10-5-3 obviously will significantly benefit those industries that currently labor under the longest depreciation lives. It will be of little or no benefit to those that already utilize the shortest lives. This is not a fault; it is a direct result of the effort to eliminate useful life depreciation and to reduce the high cost of capital that has been borne by some industries. If it were appropriate to continue the existing wide spread between short and long write-off periods, we would not be discussing faster cost recovery legislation because the rate of recovery could not be improved.

While 10-5-3 is not intended to improve the rate of recovery for sectors that already utilize the fastest possible methods, neither should it penalize any such sectors. If the case is made that particular features of S. 287 or ACRS create such a result, we would recommend alleviating the problem.

Loss industries. Neither 10-5-3 nor any depreciation improvements can provide a significant immediate benefit to non-profitable or low profit firms; one must have income against which to claim deductions. But this is not a shortcoming of the proposal because it is not intended as a support system for troubled industries. Tax law should not be applied either to assist or penalize firms. It should be a broad based structure that raises essential revenues while imposing the least possible impediment to economic forces. In this context, 10-5-3's principal immediate beneficiaries will be the vast majority of profitable business sectors that want to modernize and expand with the long-term expectation of improved vitality. Even non-profitable firms anticipate returning to a healthy position in a revitalized economy. When they do, it is certain that they will want to benefit from 10-5-3.

Capital goods industries. However, when considering the potential beneficiaries of such "supply-side" tax cuts, it is important to keep in mind the demand-side features of 10-5-3. For example, one industry that is often--but incorrectly--presumed to have little interest in 10-5-3 is steel. Yet, steel and other basic metals industries would be direct recipients of the increased capital spending stimulated by 10-5-3, as well as long-term beneficiaries for their own purposes. Likewise, the machine tool industries and other capital goods sectors would be favorably affected both as to their ability to expand and the level of demand for their products.

2-4-7-10-15/20. Last year, this Committee drafted a proposal known as 2-4-7-10 because of its four equipment categories. Two building categories of 15 and 20 years were also added. We prefer 10-5-3 to this approach because the latter fails to meet the objectives of eliminating useful lives and simplifying cost recovery

rules. In fact, the approach is based on ADR's estimate of useful lives which are reduced by 40% and then rounded down to one of the four categories. This continues the tax-induced high cost of investments in longer lived assets.

More importantly, it creates the potential for new biases among and within industries by dividing their assets arbitrarily among the categories. For example, industries with a 12 or 13 year ADR guideline (such as those making pulp and paper, fabricated metal products, electrical equipment, automobiles, ships, railroad cars, and scientific and engineering equipment) would fall to seven years. Those with a 10 or 11 year guideline (such as those making wood products and furniture, converted paper and pulp, finished plastics products, general machinery and parts, airplanes and locomotives) would fall to four years. Many of these examples are competitive industries or affect competitive firms within a general industry where the new categories would create larger spreads than current useful lives. Varying the categories may eliminate the problems while creating new problems.

In addition, such categories are based on a faith that current ADR guideline lives are correct. Since 1971, many of these guidelines have been revised but many have not. Many of these revisions may now need revisions, and all of this affects the potential 2-4-7-10 categories.

The 10-5-3 approach would avoid all of these problems.

Accounting features. While 10-5-3 should not be structured to assist distressed firms, neither should its accounting techniques be constructed in such a way as to compress large deductions into lean years, thereby pushing more firms into uncertainty over the long-term availability of tax benefits. Under S. 287, the "discretionary use" or "flexibility" of the maximum allowable 10-5-3 deductions would reduce the pressures that mandatory deductions would place on firms making large capital investments during periods of low profitability. It would insure full use of deductions and investment credits, thereby making investment planning much more certain. We recommend your inclusion of a discretionary use feature like that in S. 287 rather than the mandatory deduction under ACRS.

An additional important accounting feature affects the time at which deductions can be taken. The theory underlying 10-5-3 is to create a system that allows the taxpayer to recover capital very rapidly, rather than to take depreciation deductions over estimated useful lives. This naturally leads to allowing deductions to begin when capital is invested, not when the asset begins its useful life. We recommend the adoption of the S. 287 rule that allows deductions to begin when costs are paid rather than the ACRS placed-in-service and progress expenditure rules.

One final accounting point deals with the exclusion of foreign-located assets from ACRS. If such assets are not covered by

the system, then they should at least be left unaffected. ACRS proposes a set of modified recovery periods that can be detrimental in certain situations.

Buildings. A sizable portion of the capital investment covered by 10-5-3 will be in buildings. The dramatic change proposed in cost recovery for productive structures has caused questions to be asked about the appropriateness of such an improvement. The change is quite appropriate, but a large part of the lack of understanding is due to industry's failure to press the case during the last twenty years or so.

Simply put, a building is just as much a capital asset as the machine in the assembly line or the delivery truck on the road. Manufacturers' primary concern has been--and continues to be--machinery and equipment. But we strongly support the 10-year category because a cost recovery system that fails to make a radical improvement in this area would be deficient. Equipment needs a roof and walls around it. Changing industrial technologies are demanding complete overhauls of many buildings. Rising fuel prices are dictating more attention to energy efficient structures. And for our friends in the distribution sectors, their buildings are their most important capital assets. Attention to their needs is a critical element in a cost recovery program for the business community.

Any Unintended Results?

Real estate tax shelters. Flowing from the questions about the 10-year category is a concern that it will stimulate the construction of border-to-border office buildings and shopping centers by investors seeking to generate huge tax deductions to shelter other income. Presumably, this is considered wrong in and of itself. While the complaint is an interesting one, the facts are that both S. 287 and ACRS take significant steps to discourage such action while improving the climate for investments in mainline business structures such as factories, distribution centers and retail stores.

Owners who use buildings in their own businesses do not regularly buy and sell their interests in buildings every few years and, therefore, they are not concerned with a feature of tax law known as sec. 1250 recapture that converts ordinary income deductions into capital gains when a building is sold. Rather, it is the tax motivated investor who has an interest. We call your attention to the fact that S. 287 would repeal sec. 1250 for such ventures. ACRS would allow sec. 1250 only in its 15-year straightline category for leased structures, office buildings and low income housing and in its 18-year straightline category for residential rental buildings.

This Committee has made a significant contribution to the capital recovery discussion by introducing the owner-user versus lessor distinction in your bill last year. Unless someone has developed a better means of accommodating both needs, NAM believes that the effect of 10-5-3 with this distinction will be to leave alone rather than to enhance the "tax shelter" real estate ventures.

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Relocations. While considering buildings, also consider the fear that 10-5-3 will encourage relocations from the snowbelt to the sunbelt. The rapid growth of industry in the sunbelt is a function of many factors such as markets, energy, raw materials, transportation, labor supply and local economies. Concern should be expressed not for the firm that is forced to move by such factors; if the move is essential to survival, it will be made. Rather, concern should be directed to the firm which must rejuvenate or die because it has no better place to go. In fact, 10-5-3 could enable such firms to rebuild rather than simply go out of business altogether. Federal tax law is not now--and should not become--a rope for a regional tug-of-war. It should not be skewed toward any type of business or location.

A major element of this concern appears to be the result of failure to emphasize one simple fact--10-5-3 will apply to rehabilitation and modernization of existing buildings as well as to new buildings.

Neutrality. One of the most interesting points that has been raised is the need to develop a "neutral" cost recovery system. Unfortunately, tax neutrality is perceived only in the eye of the beholder, so this discussion is not likely to produce many converts. But for the sake of information, let us note that 10-5-3 is based on the view, that NAM shares, that a neutral recovery system is one that does not influence investors' decisions regarding the composition of their capital assets. Where the current useful life concept treats different types of machinery in different ways and thereby affects the cost of various investment decisions, 10-5-3 provides one machinery category so the investor can make investment choices on other grounds. This, we believe, is the proper view.

However, another point of view argues that the useful life approach is correct and that 10-5-3 would distort decisions compared to current law. The general theme to this argument has been that buildings and long-lived equipment would benefit at the expense of short-lived assets. But a new twist was added by some recent commentators suggesting a 10-5-3 bias in favor of buying short-lived assets as the means to hyping next year's profits. Whichever view a critic takes, our view is that current law is not the reference point against which to measure investment distortions; current law produces distortions through tax-induced higher costs of investing in long-lived assets. 10-5-3 seeks to achieve a neutral system that removes tax-oriented considerations from the investment process. (A lengthy discussion of this point is provided in an NAM TAXATION REPORT dated March 5, 1981.)

FYCR. When discussing neutrality, one well-developed--and now redeveloped--approach is always noted, that of Harvard University economists Dale Jorgenson and Alan Auerbach whose solution is first year capital recovery (FYCR) to allow a one time deduction of a percentage of the cost of an asset. The percentage would be

determined by calculating the present value of the asset's actual economic depreciation. As a means for removing the effects of inflation from depreciation, this has an alluring appeal. As a means for improving the rate of recovery on productive assets, it offers little comfort. While maintaining a depreciation system controlled by Treasury economists who study used asset prices to determine economic depreciation, FYCR seeks to provide virtually the same tax savings available under current law. Those who support 10-5-3 have made a case for faster recovery--not for a different version of the status quo.

There are other fundamental problems with FYCR. By continuing to discriminate among assets of differing lives, FYCR continues existing law's tax-induced higher cost of investing in some assets. By attempting to determine true economic depreciation based on used asset prices, FYCR will resemble a dog chasing its tail because the system and the data base of prices will continually influence one another. By requiring deductions that are fixed by Treasury staff, the system will open a massive new area for confrontation and lobbying to have specific lives changed.

Many of these problems were pointed out when FYCR was first presented to this Committee last summer. A revised form of FYCR now offers a gerry-rigged system with 35 categories and variable investment tax credits to achieve almost any desired result. But the basic problems remain.

Expensing. A very interesting related point is the concern that the combination of 10-5-3 deductions plus the investment tax credit (ITC) will produce a result that is better than a one-year write off or "expensing." This means that the present value of the stream of 10-5-3/ITC tax reductions exceeds the value of the tax savings of expensing. Given a lower rate of inflation than we currently see, this result might be produced by the end of the phase in on equipment. It certainly would not be the result when all capital assets including buildings are considered.

But, if this is a problem, it is one that will result from any system that combines a write-off period with a tax credit; only the interest rates will be different. If this argument is truly a serious objection--if it is not merely a rhetorical debating point--then those who are concerned should make a constructive contribution to the 10-5-3 discussion. They should propose immediate expensing.

Investment delay. Finally, there is the often heard and seemingly sound objection that 10-5-3's five-year phase in period will actually inhibit rather than encourage investment because it will entice firms to delay until the maximum benefits are available. But the apparent common sense of delayed investments fails to consider the financial reality of what is lost during the interim period. A decision to invest in a new machine under current law is based on a conclusion that such use of the firm's capital will produce a better income stream than an alternate one. Delaying such an investment for

five or more years can produce a faster write off later, but it will result in a less profitable income stream currently. Therefore, the already planned investment will not be delayed.

Net new investments will be stimulated during the phase in when the combination of many factors--including the cost recovery rules--overcomes the reasons for not investing. For some investment, this may occur in the first year of the phase in. For others, it will be later or at the end. But whatever the point, the phase in itself will not delay the investment. Awaiting the shortest recovery period is viable only if a better return is available during the interim. If that return is available, the investment would not be made anyway.

ADDITIONAL TAX PROPOSALS

The President's recommendation that Congress develop two tax packages has not received the support that NAM believes it deserves. The need to give prompt attention to the capital recovery and rate reduction proposals argues strongly for considering other proposals later. If the Committee's agenda is opened to the wide range of issues that have large constituencies, we are concerned that the July 31 timetable for Congressional completion of the tax bill, already agreed to in the House, will be long delayed.

NAM has views on many tax measures that may be raised. But we urge that they be held for consideration until after the Committee has completed work on the President's package. We are urging our members not to be the first to press for action on such measures. We ask that the Committee's mark-up agenda be drafted to reflect this approach.

CONCLUSION

NAM is supporting the President's entire economic recovery package as an essential change in the direction of the economy. Its importance lies in both its individual pieces and in its potential impact when enacted as a package. We commend this Committee for its recent action on spending cuts. We urge you to take the next step with the President by enacting the 10-5-3 and rate cut proposals as the specific items of the tax cut.

TESTIMONY OF

MR. J. PETER GRACE

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

W. R. GRACE & CO.

Before the

SENATE FINANCE COMMITTEE

Washington, D. C.

May 19th, 1981

When the economic history of 20th Century America is written, the record of the 97th Congress will occupy a crucial chapter. It will be recorded either that this Congress had the wisdom and foresight to halt the accelerating economic deterioration or that this Congress let slip perhaps the last chance to prevent a financial collapse that destroyed private enterprise and, thus, the foundation of our economic and personal freedoms. The American people have seen the need and they spoke clearly last November -- they want less spending and lower taxes.

No issue before this Congress is more vital to the survival of our free enterprise system than the tax reductions proposed by President Reagan. By now there should be no debate on whether taxes are constricting output and economic growth. Both the size and the incidence of the tax burden reduce the incentives to work, produce, save and invest. In short, the "work ethic" which pushed this country to pre-eminence among world economies has been stifled.

Contrary to the simplistic view that increased taxes have been required to balance federal income with federal spending, higher taxes have been accompanied by increasing federal deficits, as federal spending has been unrestrained. The following shows the trends in federal spending, deficits and resulting deterioration in the U. S. economy for successive seven-year periods:

(Chart follows)

THE DETERIORATING U.S. ECONOMY

	(1)	(2)	(3)	(4)
	7 Years Ending			% (Deterioration)
	1966	1973	1980	1966-1980
(1) Federal Spending as % of GNP (Average %)	18.8 %	20.4 %	22.0 %	(17.0)%
(2) Unemployment Rate (Average %)	5.3	4.6	6.8	(28.3)
(3) Real GNP (Avg. Ann. % Change)	4.5	3.5	2.4	(46.7)
(4) Real Business Investment (Avg. Ann. % Change)	7.9	3.6	2.0	(74.7)
(5) Productivity (Avg. Ann. % Change)	3.4	2.1	0.5	(85.3)
(6) Inflation (Avg. Ann. % Change)	1.5	4.6	9.2	(513.3)
(7) Federal Deficit (Average, $ Billions)	$(1.3)	$(9.7)	$(41.8)	(3,115.4)

As brought out, federal spending has increased from 18.8% of GNP in the seven years ending with 1966 to 22.0% in the seven years ending with 1980, an increase (deterioration) of (17.0)%. At the same time, as brought out on the bottom line of the preceding, the federal deficit increased from an average of $(1.3) billion in the early period to $(41.8) billion in the most recent seven-year period, a deterioration of (3,115.4)%. Thus, increasing taxes have not resulted in greater fiscal integrity, quite the opposite. The evidence is strong that our economic problems have been the result of this lack of fiscal responsibility. There is no question in my mind as to the adverse effect of the increasing burden of taxes on the rate of business investment. The numbers express the deterioration eloquently for the latest seven years as compared with the earlier seven years:

Real Business Investment Rate down (74.7)%
Productivity Gain down (85.3)%
Inflation Rate up (513.3)%

The effect on the overall economy shows up in the (46.7)% slower growth in real GNP and the unemployment rate up by (28.3)%.

The economic deterioration in the U. S. economy has placed the nation in a very much weakened position relative to other major countries, as seen in the following:

(Chart follows)

ECONOMIC PERFORMANCE
IN EIGHT COUNTRIES, 1962-1980

	(1)	(2)	(3)	(4)
	1962 - 1980			
	Government Spending As % Of GNP(a) (Average Over Period)	Average Investment As % Of GNP (Average Over Period)	Real GNP (Avg. Ann. % Increase)	Productivity (Avg. Ann. % Increase)
(1) Japan	8.7%	32.5%	7.9%	7.8%
(2) Belgium	15.0	21.5	3.9	6.6
(3) Netherlands	16.8	23.6	4.1	6.4
(4) Italy	15.4	20.6	4.1	5.6
(5) France	13.8	22.9	4.4	5.4
(6) Germany	17.5	20.6	3.6	5.2
(7) United Kingdom	18.7	18.4	2.3	2.7
(8) United States	20.6	17.8	3.5	2.2

Japan Versus U.S.

58%	Lower Gov't Expenditures
83%	Higher Investment Rate
126%	Higher GNP Growth
3.5X	Productivity Growth

(a) Federal, state and local current spending excluding transfer payments and capital spending.

U. S. productivity performance during the years 1962-1980 was the worst of the eight countries and corresponds with the U. S. ranked lowest on the investment rate and second lowest on real GNP growth, exceeding only the U. K. in this regard. All this relates back to the bite the government takes out of the economy for current spending which at 20.6% during the years 1962-1980 was the highest for any of these countries. The performance as compared with Japan is unfavorable for the U. S. in the extreme with:

Japan's investment rate 83% higher than the U. S.

Japan's GNP growth at 126% higher

Productivity gain in Japan 3.5x that of the U. S.

We see the net of this in the share of world output for the U. S. vs. other major areas.

(Chart follows)

U.S.'s DECLINING SHARE OF WORLD OUTPUT
(Percent of World GNP)

		(1)	(2)	(3)	(4)	(5)
		1953	1960	1970	1980	1980 as Multiple of 1953
(1)	Japan	3.9%	5.1%	8.8%	10.1%	2.6X
(2)	LDC's	20.7	18.7	18.2	21.9	1.1
(3)	France	5.2	5.5	5.6	5.5	1.1
(4)	West Germany	7.0	8.7	8.2	7.3	1.0
(5)	EEC	25.2	26.9	25.4	22.9	0.9
(6)	U.S.	31.4	28.0	24.6	22.8	0.7
(7)	U.K.	6.3	5.8	4.6	3.7	0.6

The diminished share of U. S. output relative to the other major areas is of great concern in the context of the required build-up of our defense umbrella. As compared with the 31.4% of world output accounted for by the U. S. in 1953 and the 28.0% share in 1960, that percentage in 1980 was down to 22.8%.

These overall unfavorable trends are reflected finally in the deteriorating position of the consumer in the U. S. The following from recently developed OECD data show that the U. S. worker was unique in suffering a real decline in disposable personal income between 1972 and 1979:

(Chart follows)

TRENDS IN DISPOSABLE INCOME
AND CONSUMER PRICES
% Increase/(Decrease) 1972-1979

		(1) Disposable Income (a)	(2) Consumer Prices	(3) % Pts. Disposable Income Growth Above/(Below) Consumer Price Increase
(1)	Italy	262%	175%	87%Pts.
(2)	Belgium	123	73	50
(3)	Luxembourg	108	62	46
(4)	Portugal	293	251	42
(5)	New Zealand	176	135	41
(6)	Denmark	134	102	32
(7)	Finland	159	127	32
(8)	Germany	71	41	30
(9)	Ireland	187	157	30
(10)	Norway	105	77	28
(11)	Australia	143	115	28
(12)	Austria	79	55	24
(13)	Canada	105	82	23
(14)	France	118	98	20
(15)	Japan	115	98	17
(16)	Switzerland	51	37	14
(17)	Netherlands	73	64	9
(18)	Sweden	93	87	6
(19)	United Kingdom	169	167	2
(20)	Greece	184	183	1
(21)	United States	68	74	(6)

Due to inflation and tax bracket creep, the United States was the only OECD country to experience declining real disposable income between 1972 and 1979

(a) Gross income minus income and Social Security taxes. Average for one-earner married couple with two children.

The U. S. ranked below such poorly performing economies as Sweden, the U. K. and Greece during 1972-1979. All of the European economies, Australia, Canada and Japan ranked well above the U. S., so that the average worker in the U. S. saw his living standard deteriorate both in absolute terms and relative to workers in all of these other countries.

As noted at the outset, there is a close relationship between the growth of government in the U. S. and poor economic performance. The next chart shows that part of our GNP which is under government control, including the wide range of transfer payments, in relation to the part of GNP under private sector control:

(Chart follows)

GOVERNMENT CONTROLLING MORE OF THE PRIVATE ECONOMY
(Billions of Current $)

		(1)	(2)	(3)	(4)	(5)
		GNP			Government Control As % Of	
		Total	Private Sector Control	Government Control	Total GNP	Private Sector
(1)	1948	$ 259.5	$ 209.0	$ 50.5	19.5 %	24.2 %
(2)	1953	366.8	265.2	101.6	27.7	38.3
(3)	1958	449.7	322.1	127.6	28.4	39.6
(4)	1963	596.7	428.9	167.8	28.1	39.1
(5)	1968	873.4	604.3	269.1	30.8	44.5
(6)	1973	1,326.4	921.1	405.3	30.6	44.0
(7)	1978	2,156.1	1,474.2	681.9	31.6	46.3
(8)	1979	2,413.9	1,660.7	753.2	31.2	45.4
(9)	1980	2,627.4	1,758.4	869.0	33.1	49.4
(10)	1980 As Multiple Of 1948	10.1X	8.4X	17.2X		

Government has increased as a percent of the Private Sector by 104.1% in the 32 years, 1948-1980.

As a percent of the GNP controlled by the private sector, government has increased from 24.2% in 1948 to 49.4% in 1980, i.e., more than doubled.

The increased role of government in our nation's economic activity impinges on overall economic performance in a variety of ways in addition to its direct inflationary effects. Because financing of federal government deficits has to be accommodated out of the total of credit market borrowings, federal borrowing crowds out the private sector in capital markets.

(Chart follows)

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FEDERAL GOVERNMENT CROWDING-OUT PRIVATE INVESTMENT

(Billions of Current $, Average of Period)

	Years	(1) Total Credit Market Borrowings	(2) Federal Borrowings	(3) Federal As % of Total
(1)	1955-1959	$ 43.2	$ 2.4	6 %
(2)	1960-1964	60.6	5.3	9
(3)	1965-1969	98.7	10.0	10
(4)	1970-1974	193.8	27.8	14
(5)	1975-1979	375.2	91.1	24
(6)	1980	434.1	126.8	29

Federal Government preempting 5 times the 1955/59 position in credit markets.

In the second quarter of 1980 the government appropriated 40.8% of total credit market borrowings.

As seen in column (3), federal borrowings in 1980 accounted for 29% of all credit market activity or almost five times the 1955-59 share. It was as high as 40.8% in the second quarter of 1980, the same quarter, you may recall, that the prime rate hit 20% for the first time in history. Record high interest rates act as a deterrent to private sector borrowers but not to the insatiable government. The effect in terms of higher interest rates in the U. S. as compared with other countries can be seen as follows:

(Chart follows)

PRIME INTEREST RATES
(Year-End Rates)

		(1)	(2)	(3)	(4)
		1972	1976	Latest	Latest As Multiple Of 1972
(1)	Switzerland	7.00%	7.50%	7.00%	1.0X
(2)	Japan	6.33	7.42	6.75	1.1
(3)	Germany	8.50	6.50	11.50	1.4
(4)	U. K.	8.50	15.50	13.00	1.5
(5)	France	9.15	11.65	17.00	1.9
(6)	U. S.	4.50	6.25	19.50	4.3
	U.S. As % Of:				
	Switzerland	64%	83%	279%	
	Japan	71	84	289	

One result of rapid growth of government in the U. S. is that our economy is becoming more and more like socialist economies such as Sweden, characterized by an increasing weight of social benefits and other transfer payments, seen as follows:

(Chart follows)

GALLOPING SOCIALISM: THE U.S.'s MIXED ECONOMY BECOMES LESS MIXED

Transfer Payments as a Percent of Gross Domestic Product

		(1) Average Per Year 1955-57	(2) Average Per Year 1976-78	(3) 1976-78 As Multiple Of 1955-57
(1)	Spain	1.7%	9.9%	5.82X
(2)	Netherlands	8.1	26.8	3.30
(3)	United States	4.1	10.9	2.66
(4)	Sweden	7.4	19.3	2.61
(5)	Norway	6.6	16.5	2.50
(6)	Japan	3.7	9.2	2.49
(7)	Ireland	6.5	14.9	2.29
(8)	Belgium	9.4	20.5	2.18
(9)	Switzerland	5.2	10.8	2.08
(10)	Denmark	7.1	14.7	2.07
(11)	New Zealand	6.4	13.0	2.03
(12)	OECD Average	7.5	15.2	2.03
(13)	United Kingdom	6.1	11.8	1.93
(14)	Canada	5.8	10.5	1.81
(15)	Australia	5.2	9.3	1.79
(16)	Finland	5.4	9.5	1.76
(17)	Austria	10.2	17.1	1.68
(18)	Italy	9.7	16.1	1.66
(19)	France	13.2	21.7	1.64
(20)	Greece	5.3	8.5	1.60
(21)	Germany	12.0	16.5	1.38

At this rate, in 12 years transfer payments in the U.S. will usurp the same percent of gross domestic product as in socialist Sweden

The preceding data, recently developed by the OECD, show that transfer payments as a percent of gross domestic product in the U. S. have increased more than 2½ times on average from the period 1955-57 to the period 1976-78, from 4.1% to 10.9%. At the rate that these payments are increasing in the U. S., we will be in the current position of Sweden in about 12 years. In other words, the present trend of transfer payments in the U. S. will soon convert our previously productive private enterprise system to the controlled pattern of socialist countries.

These transfer payments, per the last budget presented by the previous Administration, have a frightening growth characteristic as shown in the following:

(Chart follows)

U.S. GOVERNMENT TRANSFER PAYMENTS
(Billions of Current $)

		(1)	(2)
	Fiscal Year	Amount	1984 Budget As Multiple Of Each Year
(1)	1960	$ 23.6	18.3X
(2)	1965	32.3	13.3
(3)	1970	63.2	6.8
(4)	1975	150.4	2.9
(5)	1979	227.5	1.9
(6)	1980	271.2	1.6
	Carter Budget		
(7)	1981	319.2	1.4
(8)	1982	353.4	1.2
(9)	1983	393.3	1.1
(10)	1984	431.1	1.0
(11)	1980 As Multiple Of 1960	11.5X	

As a share of total government expenditures, transfer payments have risen from 25.6% in 1960 to a budgeted 48.4% in 1984.

In the latest complete year, fiscal 1980, U. S. government transfer payments were up by a multiple of 11.5X those payments in 1960. For 1984, they were budgeted by the Carter Administration to rise to 48.4% of total government expenditures, up from the 25.6% of 1960. It is hard to see how fiscal responsibility can be restored without tackling the increasing burden of these payments.

It is encouraging that the spending proposals of the present Administration provide for some reduction in the spending proposals of the Carter Administration. However, even with the proposed budget cuts, the spending by the present Administration will continue the pattern of year-to-year increases, as shown in the following:

(Chart follows)

PLANNED SPENDING REDUCTIONS
(Billions of Current $)

	Fiscal Year	(1) Budgeted Outlays: Per Carter Budget	(2) Budgeted Outlays: Per Reagan Budget	(3) Budgeted Outlays: % Reagan (Under) Carter	(4) % Over Previous Year: Carter Budget	(5) % Over Previous Year: Reagan Budget
(1)	1980	$579.6 Act.		-	17.4 %	
(2)	1981E	$ 662.7	$ 656.6	(0.9)%	14.3	13.3 %
(3)	1982E	739.3	699.0	(5.5)	11.6	6.5
(4)	1983E	817.3	759.2	(7.1)	10.6	8.6
(5)	1984E	890.3	818.7	(8.0)	8.9	7.8
(6)	1985E	967.9	886.2	(8.4)	8.7	8.2
(7)	1986E	1,050.3	959.0	(8.7)	8.5	8.2
	% Increase					
(8)	1980 - 1986	81.2%	65.4%			

$302.4 billion increase is $32.8 billion more than total Federal outlays in 1974.

REAGAN BUDGET "DECREASES"

I suggest that greater attention should be focused on the increases in federal spending as proposed in the Reagan budget. The news media refer almost constantly to Reagan budget "decreases" whereas there are no decreases in relation to prior years.

However we look at it, government spending and the associated tax burden have been increasing at exceptional rates and constitute major retardants to productivity and growth, and to the control of inflation. The next chart shows the related trends in taxes, output, productivity and inflation:

(Chart follows)

TAXES ARE STRANGLING THE ECONOMY
Indexes based on 1960 = 100

	(1) Taxes	(2) Output	(3) Productivity	(4) Prices
(1) 1960	100.0	100.0	100.0	100.0
(2) 1965	133.9	126.9	120.4	108.3
(3) 1970	213.6	146.6	132.2	133.0
(4) 1975	328.8	162.2	142.5	185.2
(5) 1976	377.5	172.7	147.6	194.7
(6) 1977	423.9	182.8	150.3	206.3
(7) 1978	480.5	192.2	151.0	221.4
(8) 1979	543.5	196.7	149.7	241.0
(9) 1979 as Multiple of 1960	5.4X	2.0X	1.5X	2.4X

Taxes are up more than 2 1/2 times output and more than 3 1/2 times productivity. No wonder that inflation outpaces both output and productivity.

From a 1960 base, taxes in the U. S. were up more than five-fold in 1979. This is 2½ times the two-fold increase in output and 3½ times the 1.5 multiple for productivity for the same period. Concurrently, the price index was up by a 2.4 multiple. In net, the rise in taxes and related government spending and deficits outpaced all these indicators, restricting output and productivity and increasing inflationary pressures.

We have often heard that the cost of energy has been the chief problem of the U. S. economy in recent years. The following compares the increases in energy costs with the increases in federal taxes.

(Chart follows)

CONSUMER COSTS OF ENERGY AND TAXES, 1970-1980
(Billions Of Current Dollars)

		(1)	(2)	(3)	(4)	(5)	(6)	(7)
		Energy			Federal Taxes			
		Gasoline	All Other	Total	Personal Income	Social Security	Excise, Estate And Gift	Total
(1)	1970	$ 22.4	$ 19.8	$ 42.2	$ 88.8	$ 49.3	$ 19.4	$ 157.5
(2)	1971	23.9	21.5	45.4	85.7	54.4	20.6	160.7
(3)	1972	25.4	23.8	49.2	102.7	62.7	21.0	186.4
(4)	1973	28.6	26.7	55.3	109.5	79.5	21.8	210.8
(5)	1974	36.6	31.7	68.3	126.4	89.8	21.3	237.5
(6)	1975	40.4	37.4	77.8	120.8	94.1	21.3	236.2
(7)	1976	44.0	42.7	86.7	141.5	106.5	22.6	270.6
(8)	1977	48.2	48.8	97.0	162.7	118.5	24.7	305.9
(9)	1978	52.7	54.2	106.9	189.4	137.2	23.8	350.4
(10)	1979	68.4	63.3	131.7	225.7	159.0	24.1	408.8
(11)	1980	89.1	66.9	156.0	251.0	172.2	35.7	458.9
	Amount Increase							
(12)	1970-1980	$ 66.7	$ 47.1	$ 113.8	$ 162.2	$ 122.9	$ 16.3	$ 301.4
(13)	1975-1980	48.7	29.5	78.2	130.2	78.1	14.4	222.7

Federal Taxes Up By A Multiple Of 2.8X Energy

From the base of 1975, energy costs were up by $78.2 billion in 1980. At the same time, the federal tax take increased by $222.7 billion or by a multiple of 2.8 times the increase in the cost of energy. In other words, tax increases were a much greater total dollar burden on the economy.

One of the ways in which tax increases impact on productivity is through the penalty placed on second incomes, from wives who may enter the work force, as shown in the following:

(Chart follows)

THE TAX PENALTY ON SECOND INCOMES:
ADDITIONAL INCOME AND SOCIAL SECURITY
TAXES PAID WHEN A WIFE WORKS
(As % of Wife's Gross Earnings)

		(1)	(2)	(3)	(4)
	Country	Income Tax (a)	Employee's Social Security	Total	U.S. Total As Multiple Of Each
(1)	United States	29%	6%	35%	1.00X
(2)	Germany	16	16	32	1.09
(3)	Netherlands	13	18	31	1.13
(4)	Sweden	31	-	31	1.13
(5)	Luxembourg	16	12	28	1.25
(6)	Finland	23	3	26	1.35
(7)	Switzerland	11	10	21	1.67
(8)	France	10	10	20	1.75
(9)	Canada	16	3	19	1.84
(10)	New Zealand	19	-	19	1.84
(11)	Belgium	7	11	18	1.94
(12)	Austria	5	13	18	1.94
(13)	Australia	16	-	16	2.19
(14)	Italy	7	8	15	2.33
(15)	Japan	9	5	14	2.50
(16)	United Kingdom	8	2	10	3.50

Husband/wife team taxed 3.5X U.K.

(a) Assumes wife's earnings are 33% of her husband's and husband is an average production worker.

The preceding shows the extreme disincentive for wives to work in the United States as compared to other countries. For example, the 35% tax rate on a wife's gross earnings in the U. S. is 3.5 times the same factor in the United Kingdom, 2.5 times the same factor in Japan, and higher also than in all other major European countries and in Canada.

Estate and gift taxes are another aspect of the disincentive for productive enterprise in the U. S., as follows:

(Chart follows)

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THE HIGH COST OF DYING

Death and Gift Taxes as a Percent of Gross Domestic Product

		(1) Percent	(2) U.S. % As A Multiple Of Each	
(1)	United States	0.42%	1.00X	
(2)	Australia	0.41	1.02	
(3)	New Zealand	0.41	1.02	
(4)	United Kingdom	0.32	1.31	
(5)	Belgium	0.30	1.40	
(6)	Switzerland	0.23	1.83	
(7)	Ireland	0.21	2.00	
(8)	Japan	0.19	2.21	
(9)	France	0.18	2.33	◄ France
(10)	Denmark	0.18	2.33	
(11)	Netherlands	0.18	2.33	
(12)	Luxembourg	0.14	3.00	
(13)	Portugal	0.13	3.23	
(14)	Spain	0.13	3.23	
(15)	Sweden	0.11	3.82	
(16)	Finland	0.10	4.20	
(17)	Germany	0.09	4.67	◄ Germany
(18)	Canada	0.07	6.00	
(19)	Norway	0.07	6.00	
(20)	Italy	0.07	6.00	◄ Italy
(21)	Austria	0.06	7.00	

Death and gift taxes as a percent of gross domestic product in the U. S. at 0.42% are proportionately higher than in any of the other OECD countries. The percent in the U. S. is six times that of Italy, over 4½ times that of Germany, and 2.33 times that of France.

Taxes have a directly negative effect on savings as seen in the following:

(Chart follows)

IMPACT OF TAXES ON SAVINGS

	(1)	(2)	(3)	(4)
	U. S. Average Tax Rate	Average Savings Rates		
		U. S.	Germany	Japan
(1) 1960-1963	26.6 %	5.1 %	14.9 %	18.3 %
(2) 1964-1976	25.2	6.8	14.8	18.9
(3) 1977-1978	31.4	4.9	12.6	18.9
(4) 1979	32.6	4.5	13.5	18.4

RAISE TAXES AND SAVINGS GO DOWN. IF YOU WANT TO INCREASE SAVINGS AND INVESTMENT, CUT TAXES.

When the U. S. average tax rate was reduced from the 26.6% during the period 1960-1963 to 25.2% average during the years 1964-1976, the savings rate in the U. S. increased from 5.1% of disposable income to 6.8%.

Correspondingly, during the years 1977 and 1978, when the average U. S. tax rate increased to 31.4%, the U. S. savings rate fell abruptly to 4.9%. And, in 1979, when the average U. S. tax rate increased further to 32.6%, the savings rate fell to a low of 4.5%.

The message of all this is unmistakeable: take away the fruits of productive investment and labor and you destroy the incentive to save and invest in the future.

The only group that benefits tax-wise from inflation is the Federal Government. As the following shows, tax revenues are increased by inflation and legislated tax reductions have not come close to offsetting this effect:

(Chart follows)

THE CASE FOR TAX INDEXATION

EFFECT OF INFLATION AND FEDERAL TAX
REDUCTIONS ON A FAMILY OF FOUR, 1972-1980
(In Constant 1972 Dollrs)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
				Increase/(Decrease) In Taxes, 1972-1980, Due To:			% Of Inflation Increase Kept By Fed. Gov't.
	Pretax Income	Tax Paid 1972	Tax Paid 1980	Net Increase	Inflation	Tax Reductions	
(1)	$10,000	$ 753	$1,002	$ 249	$ 306	$ (57)	81.4%
(2)	15,000	1,501	1,950	449	555	(106)	80.9
(3)	20,000	2,360	3,134	774	959	(185)	80.7
(4)	25,000	3,330	4,637	1,307	1,503	(196)	87.0
(5)	30,000	4,412	7,264	2,852	3,141	(289)	90.8
(6)	40,000	7,028	10,064	3,036	3,446	(410)	88.1
(7)	50,000	10,130	14,222	4,092	4,510	(418)	90.7
(8)	100,000	29,060	37,774	8,714	9,346	(632)	93.2

In total, according to the U.S. Treasury Department,
each 1% increase in taxable income
raises Federal revenues by 1.6%.

For all levels of pretax income, the Federal Government has benefitted tax-wise from the effect of inflation. For example, at the $40,000 pretax income level, over the period 1972-1980, the government kept 88.1% of the tax increase that resulted from inflation. In total, each 1% increase in taxable income has been calculated by the U. S. Treasury to raise federal revenues by 1.6%.

There is clearly a tide running in this country for substantial tax reductions. My concern is that we will undershoot the amount of tax reduction that is needed to get the economy back on track. There is no doubt from all the evidence at hand that tax reductions have a stimulative effect on investment and income and that, therefore, the immediate reduction in tax revenues from a drop in the tax rate is soon offset by an enlargement of the tax base. The following shows one calculation of this effect:

(Chart follows)

COSTS OF REDUCING MAXIMUM TAX
RATE ON PERSONAL INCOME, 1980

		(1)	(2)	(3)	(4)
			Loss Of Revenue By Reducing From 70%		
	Maximum Tax Rate	Income Tax Generated (Billion $)	Amount (Billion $)	% Of $579.6 Billion Budget	% Increase In Income Required To Offset Lost Tax Revenues
(1)	70%	$244.1	-	-	-
(2)	60	242.9	$ 1.2	0.2%	0.3%
(3)	50	240.7	3.4	0.6	0.9
(4)	45	234.1	10.0	1.7	2.7
(5)	42	230.9	13.2	2.3	3.5
(6)	36	221.6	22.5	3.9	6.0

Underground Economy

Income: $250-$350 Billion

Lost Tax Revenues: $30-$50 Billion

Based on the latest available U. S. Treasury data, if the maximum tax rate had been cut from 70% to 36% in 1980, we estimate that the revenue loss would have been about $22.5 billion, or 3.9% of the 1980 Federal budget. To make up for this potential loss, taxable income generated in the economy would only have to increase by 6.0%. The $22.5 billion loss of revenue by a tax cut of this magnitude would be more than made up by increased growth and recovery of a part of the $30-$50 billion of revenue lost to the underground economy.

The case for a very substantial reduction in tax rates is reinforced when we analyze the effect of the tax bracket creep from inflation on the purchasing power of the average family. The following shows the pretax income required for a family of four to maintain its 1972 real purchasing power:

(Chart follows)

10% INFLATION TAX BRACKET CREEP

PRETAX INCOME REQUIRED FOR A FAMILY OF FOUR TO MAINTAIN 1972 REAL PURCHASING POWER [(a)]

		(1)	(2)	(3)	(4)
(1)	1972	$ 20,000	$ 30,000	$ 40,000	$ 50,000
(2)	1980	41,080	63,586	86,767	108,956
(3)	1986	76,320	119,962	160,876	198,929
(4)	1993	166,337	253,182	332,931	406,889

(a) Assuming future tax cuts proportional to 1972-1980 experience.

In 1986, the income of a family of four, in order to maintain the same $40,000 of purchasing power that it had in 1972, would have to have a pretax income of $160,876 or 302.2% higher. This assumes 10% inflation per year and includes future tax cuts proportional to those actually made during the period 1972-80. By 1993, the same family would have to have its income more than double again, to $332,931, up by 732.3% over 1972.

These trends will eventually push all wage earners into the top earned income bracket, seen as follows:

(Chart follows)

10% INFLATION TAX BRACKET CREEP
WITH NO INCREASE IN PURCHASING POWER
(Wage and Salary Income) (a)

	(1) 1972 Taxable Income	(2) 1972	(3) 1980	(4) 1986	(5) 1993
		Marginal Tax Rates			
(1)	$ 10,000	19.0%	24.0%	32.0%	50.0%
(2)	15,000	22.0	28.0	43.0	50.0
(3)	20,000	25.0	37.0	50.0	50.0
(4)	25,000	28.0	43.0	50.0	50.0
(5)	30,000	32.0	49.0	50.0	50.0
(6)	40,000	36.0	50.0	50.0	50.0
(7)	50,000	42.0	50.0	50.0	50.0
(8)	100,000	50.0	50.0	50.0	50.0

(a) Assuming future tax cuts proportional to 1972-1980 experience.

Thus, by 1993, on the basis of the experience from 1972 through 1980, all tax brackets down to $10,000 of 1972 constant dollar pretax income would be at the 50% maximum marginal tax rate on wages and salaries.

Further, while the Kemp-Roth tax reduction proposal is a very desirable move, tax bracket creep reduces its effectiveness as seen in the following:

(Table follows)

KEMP-ROTH[a] VS. BRACKET CREEP
(Billions of Current $)

		(1)	(2)	(3)	(4)
			Bracket Creep Increase		
		Income Tax Reduction	Amount	As % Of Tax Reduction	Inflation Rate (GNP Deflator)
(1)	1981	$(14.6)	$ 8.9	61.0%	9.1%
(2)	1982	(48.7)	31.5	64.7	10.4
(3)	1983	(92.9)	57.0	61.3	9.1
(4)	1984	(129.8)	87.5	67.4	8.5
(5)	1985	(152.8)	123.6	80.9	8.1
(6)	1986	(178.9)	166.1	92.9	7.5
(7)	Cumulative Six-Year Total	$(617.7)	$474.6	76.8%	65.7%(b)
				Avg. Ann.	8.8%

(a) Assumed effective July 1, 1981.
(b) Compounded

By 1986, just two years after the full effectiveness of Kemp-Roth, tax bracket creep will have taken back 92.9% of the tax reduction. The need for an indexed income tax comes out clearly in these data.

It is of interest to see where the money of a family of four has gone in recent years as compared with past periods:

(Chart follows)

WHERE DOES THE MONEY GO?

Family Of Four With 1971 Income Of $16,000

		(1)	(2)	(3)	(4)
		% Of Total Spending			
		1971	1975	1980	% Inc./(Dec.) 1980 Vs. 1971
(1)	Taxes On Income	19.1%	22.3%	27.7%	45.0%
(2)	Food	20.1	21.6	20.4	1.5
(3)	Transportation	7.9	7.4	8.0	1.3
(4)	Medical Care	4.0	3.8	4.0	-
(5)	Housing	25.0	24.0	22.5	(10.0)
(6)	Personal Care	2.3	2.1	1.9	(17.4)
(7)	Other	13.0	11.5	10.0	(23.1)
(8)	Clothing	8.6	7.3	5.5	(36.1)
(9)	Total	100.0%	100.0%	100.0%	

To The Government

It seems to me a compelling message for tax legislation that the percentage of family income that went to taxes increased from [illegible] in 1971 to 27.7% in 1980 -- now the largest single household budget item -- [illegible] 45.0% which is far and away the largest proportionate increase of any component of family spending.

We hear frequent reference to the increased cost of medical care but this item took the same 4.0% share of total family spending in 1980 as in 1971. Even food, often cited as a major culprit in inflation, increased its share only 1.5%, dwarfed by the 45.0% increase in the part of family income going to taxes.

The Keogh Plan was a worthy approach to inducing additional savings but that also has become a victim of inflation, seen as follows:

(Chart follows)

OUTDATED KEOGH PLAN
RESTRICTS SAVINGS

		(1)	(2)	(3)	(4)	(5)
		Maximum Allowable Keogh Plan Deduction		Required Deduction To Equal $7,500 In 1974 $	Required Deduction Above $7,500 Maximum	
		In Current $	In Constant 1974 $		Amount	%
(1)	1974	$7,500	$7,500	$7,500	-	-
(2)	1975	7,500	6,874	8,186	$ 686	9.1 %
(3)	1976	7,500	6,499	8,655	1,155	15.4
(4)	1977	7,500	6,103	9,218	1,718	22.9
(5)	1978	7,500	5,669	9,923	2,423	32.3
(6)	1979	7,500	5,095	11,040	3,540	47.2
(7)	1980	7,500	4,488	12,533	5,033	67.1
(8)	1981	7,500	4,026	13,973	6,473	86.3

The maximum allowable deduction under the Keogh Plan has not been increased at all since 1974. If the maximum had been raised in line with inflation, it would be $13,973 in 1981 which is $6,473 or 86.3% greater than the allowable of $7,500. Failure to index the allowable with inflation has largely eliminated the original purpose of the plan.

It is of interest to note where the personal income tax money comes from:

(Chart follows)

WHERE DID THE PERSONAL INCOME TAX MONEY COME FROM IN 1980?

	Expanded Income Level		(1) % Of Total Taxpayers		(2) % Of Total Taxable Income		(3) % Of Total Taxes Paid		(4) Ratio Of % Taxes To % Income	(5) Taxes Paid As % Of $579.6 Billion Budget
(1)	$0-$14,999		50.9%		21.9%		10.7%		0.5X	4.5%
(2)	$100,000 +		0.9		6.8		16.0		2.4	6.7
(3)		Subtotal	51.8	49.3X	28.7	9.2X	26.7	3.8X	0.9	11.2
(4)	$50,000-$99,999		3.8		8.8		13.3		1.5	5.6
(5)		Subtotal	55.6		37.5		40.0		1.1	16.8
(6)	$15,000-$49,999		44.4		62.5		60.0		1.0	25.3[a]
(7)		Total	100.0%		100.0%		100.0%		1.0X	42.1%
							Social Security Tax			27.7
							Business Taxes			11.2
							Other Revenue			8.7
							Deficit			10.3
								Total		100.0%

(a) And what they pay is only 3.7X the lost taxes from the underground economy.

As brought out, 0.9% of total taxpayers have incomes of $100,000 or more and 6.8% of all taxable income and pay 16.0% of all personal taxes. The low income group, under $15,000, who represent 50.9% of all taxpayers and 21.9% of all taxable income, pay 10.7% of all personal taxes. There is little prospect of increasing the proportions of taxes paid by these groups. Thus, increasingly the burden must fall on middle incomes, the $15,000-$49,999 groups with 44.4% of the taxpayers representing 62.5% of taxable income and paying 60.0% of all personal taxes. What this means very simply is that it has become politically more difficult to raise tax rates, i.e., increasingly, any higher tax rates to be effective in raising revenue will have to come from the 44.4% of taxpayers in the middle class.

The Kennedy Administration tax cuts of 1964 and 1965 are illustrative of the favorable revenue effects of tax cuts:

(Chart follows)

FEDERAL INCOME TAX REVENUE
DURING THE KENNEDY TAX CUTS OF 1964 AND 1965
BY INCOME CLASS
(Millions of Current Dollars)

Adjusted Gross Income Class (Thousands)	1963	1964	1965	Actual Change 1963-65	Predicted By Treasury
$0-5	$5,911	$4,668	$4,337	(27)%	(30)%
5-10	17,305	15,944	15,434	(11)%	(21)
10-15	9,430	9,972	10,712	14%	(17)
15-20	3,497	3,709	4,189	20%	
20-50	6,681	6,882	7,440	11%	(10)
50-100	2,920	3,204	3,654	25%	
100-500	1,829	2,220	2,752	46%	
500-1,000	243	306	408	68%	(13)
1,000+	327	427	603	85%	
Total	$48,204	$47,153	$49,530	3%	
Maximum marginal income tax rate	91%	77%	70%		

Source: Internal Revenue Service, Statistics of Income--1963, 1964, 1965, Individual Income Tax Returns, Tax Foundation

The Treasury Department prediction of the negative effects of the Kennedy tax cuts was completely wrong. For all income brackets of $10,000 and above, tax revenues increased by 11% to 85% compared to decreases of (10)% to (17)% predicted by the Treasury.

With regard to taxation of corporate profits, the combined effects of inflation and tax rates has been devastating, as seen in the following:

(Chart on next page)

ILLUSORY AND REAL NON-FINANCIAL CORPORATE PROFITS
($ Billions)

		(1) Reported Pretax Profits	(2) Internal Accounting Adjustment	(3) Taxes	(4) Inflation	(5) Real Profits After-Tax (1980 $)
(1)	1968	$ 72.9	$ 0.3	$ 33.4	4.4%	$ 85.5
(2)	1970	56.8	(4.2)	27.0	5.4	49.6
(3)	1975	107.3	(21.3)	41.2	9.3	63.3
(4)	1976	135.0	(27.7)	52.6	5.2	73.4
(5)	1977	154.3	(27.2)	59.4	5.8	85.9
(6)	1978	174.3	(36.7)	67.3	7.3	83.1
(7)	1979	193.4	(56.7)	69.7	8.5	73.0
(8)	1980	183.8	(60.1)	63.1	9.0	60.6
(9)	1981 Proj.	180.0	(60.0)	61.0	10.0	53.6
	Avg. Ann. % Fav./(Unfav.)					
(10)	1977-1981	3.9%	(21.9)%	(0.7)%	(1.1)%Pts.	(11.1)%

TAX AND INFLATION PENALTY

After adjusting for inflation and taxation, profits decreased from $[illegible] billion in 1977 to $53.6 billion estimated for 1981 or a decline of ([illegible])%. Reported [illegible] profits increased by [illegible] [illegible] 1977-1981 but real after-tax profits decreased by ([illegible])% [illegible] [illegible]

These trends have had a severely restraining effect on the ability of corporations to pay dividends and, thus, on incentive for investment as seen in the following:

(Chart follows)

NON-FINANCIAL CORPORATIONS

THE DEMISE OF PRODUCTIVE ENTERPRISE
(Average Annual % Change)

	(1)	(2)	(3)	(4)	(5)	(6)
	NOMINAL			REAL		
	1960-1970	1970-1976	1976-1980	1960-1970	1970-1976	1976-1980
(1) Total Sales	7.3 %	14.2 %	9.9 %	4.3 %	7.1 %	(0.4)%
(2) Pretax Profits	3.6	15.5	8.0	0.7	8.3	(2.1)
(3) Dividends	5.7	8.5	7.6	2.7	1.8	(2.4)

Steady deterioration in real dividend payout.

Corporations and individuals pay ever higher taxes on inflated profits and dividends, while in real terms these have been falling.

Nominal

	1960	1970	1976	1980
Sales (Trillions)	$ 0.8	$ 1.6	$ 3.6	$ 5.2
Pretax Profits (Billions)	39.7	56.8	135.0	183.7
Dividends (Billions)	10.6	18.5	30.1	40.4

Over the period from 1976 to 1980, sales and pretax profits increased at per annum rates of 9.9% and 8.0%, respectively. On a real constant dollar basis, there were declines of (0.4)% and (2.1)%.

On the key factor of dividends, the nominal increase of 7.6% per annum during 1976-80 netted out to a real decline at the rate of (2.4)%. There has actually been a steady deterioration in real dividend payout going back 20 years, i.e., from increases of 2.7% per annum in the decade of the sixties to 1.8% in the first half of the seventies to the (2.4)% decline in the last half of the seventies.

The climate for investment in the U. S. has been seriously undermined as compared with other countries.

(Chart follows)

TAXES ON INVESTMENT RETARD SAVINGS
AND PRODUCTIVITY IN THE U. S.

	(1) 1979 Tax Rate On Investment Income (a)	(2) Savings Rate, 1975-1979	(3) Avg. Ann. % Increase In Output Per Hour, 1973-1978
(1) France	7.3 %	17.2 %	3.9 %
(2) W. Germany	11.8	14.5	3.9
(3) Japan	14.4	21.5	3.4
(4) Canada	30.0	10.3	1.1
(5) United Kingdom	32.5	12.2	2.2
(6) United States	33.5	6.3	1.0

(a) $10,000 dividends, $5,000 interest and $34,000 capital gains coupled with $50,000 salary.

The average tax rate on investment income in the U. S. at 33.5% in 1979 was the highest for any of these countries -- 4½ times higher than in France and almost 3 times higher than in West Germany. Correspondingly, the savings rate in the U. S. was by far the lowest, almost 2/3 less than that of France and less than 1/2 West Germany's. As a result, productivity in the U. S. grew at a rate that was only about 1/4 that of France and West Germany.

Moving on now to the tax issues before this Committee, there are three basic lines of argument which have been set forth to show that the Reagan tax proposals are unfair and biased against low-income taxpayers. I believe all three arguments are incorrect, and would like to deal with each in turn.

The simplest is that the proposed cuts provide greater dollar benefits to high income taxpayers than to low-income taxpayers, and are, therefore, not fair, as follows:

(Table follows)

1984 TAX REDUCTIONS

		(1)	(2)	(3)	(4)	(5)
			1984 Tax Liability			
	1980 Gross Income	Same Income 1984 Dollars	Under Current Law	Under Reagan Plan	Reagan Plan (Under) Current Law Amount	%
(1)	$ 10,000	$13,500	$ 973	$ 688	$ (285)	(29.3)%
(2)	20,000	27,000	3,267	2,539	(728)	(22.3)
(3)	30,000	40,500	6,454	5,027	(1,427)	(22.1)
(4)	50,000	67,500	15,452	12,073	(3,379)	(21.8)
(5)	100,000	135,000	41,353	34,063	(7,470)	(18.1)

The arithmetic indeed shows that higher income brackets get greater dollar reductions in taxes, but this is irrelevant. It neglects the simple fact that, even under a straight proportional tax system where the tax rate is the same at all income brackets, tax dollars paid rise with income, and therefore a roughly equal percent cut in tax rates will yield a greater dollar benefit for higher incomes. And under our progressive tax system, as shown in the preceding, the effect is even more pronounced, with the dollar amounts of tax reduction greater for higher incomes even though in percentage terms their cuts are lower.

The second negative argument, closely related to the first, measures the tax cut in terms of percentage increases in aftertax income, as follows:

(Table follows)

REAGAN PROPOSAL VS. CURRENT LAW

1984 AFTER-TAX INCOME INCREASES

		(1)	(2)	(3)	(4)	(5)	(6)	(7)
			1984 Tax Liability (b)		1984 After-Tax Income			
							Reagan Plan Above Current Law	
	1980 Gross Income	Same Income 1984 Dollars(a)	Under Present Law	Under Reagan Plan	Under Present Law	Under Reagan Plan	Amount	%
(1)	$ 10,000	$13,500	$ 973	$ 688	$12,527	$12,812	$ 285	2.3%
(2)	20,000	27,000	3,267	2,539	23,733	24,461	728	3.1
(3)	30,000	40,500	6,454	5,027	34,046	35,473	1,427	4.2
(4)	50,000	67,500	15,452	12,073	52,048	55,427	3,379	6.5
(5)	100,000	135,000	41,353	34,063	93,647	100,937	7,470	8.0

(a) Assuming 35% inflation between 1980 and 1984.

(b) Assumes deductions equal 23% of gross income, Joint Return with 4 exemptions.

While this argument seems reasonable at first, analysis indicates that it is really the same as the first argument. Under a progressive tax system, any time tax cuts are related to aftertax income, neglecting the disparity in taxes paid, the results are misleading. To simplify, consider a tax system with only 2 tax rates: 10% for low income persons and 99% for high income persons. The following shows the change in aftertax income resulting from a 1% pt. drop in tax rates:

(Table follows)

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REDUCING PROGRESSIVE TAXES

		(1)	(2)	(3)	(4)	(5)	(6)
		Tax Rates			After-Tax Income As Percent Of Total Income		
		Current	After 1% Pt. Reduction	% Reduction	Current	1% Pt. Increase	% Increase
(1)	Low Income	10%	9%	(10.0)%	90%	91%	1.1%
(2)	High Income	99	98	(1.0)	1	2	100.0

This example shows that what is being measured is not the tax cut, but the progressivity of the original tax system. Thus, when each tax rate is reduced by 1% pt., the lower income taxpayer receives only a 1.1% gain in aftertax income, while the higher income taxpayer -- because he already pays 99% of his income in taxes -- doubles his aftertax income. Another example shows the result, by this method, of the 7.5% surtax effected in 1968, which raised everyone's taxes by an additional 7.5%.

(Table follows)

THE 1968 ACROSS THE BOARD SURTAX

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
					After-Tax Income		
1968 Gross Income	Taxable Income	Income Tax	7.5% Surtax	Tax Plus Surtax	Without Surtax	With Surtax	% Reduction
(1) $ 5,000	$ 850	$ 119	- (a)	$ 119	$ 4,881	$ 4,881	- (a)
(2) 10,000	4,700	753	56	809	9,247	9,191	(0.6)
(3) 15,000	8,550	1,501	113	1,614	13,499	13,386	(0.8)
(4) 20,000	12,400	2,360	177	2,537	17,640	17,463	(1.0)
(5) 25,000	19,250	4,170	313	4,483	22,640	22,327	(1.4)
(6) 50,000	35,500	10,130	760	10,890	39,870	39,110	(1.9)
(7) 100,000	74,000	29,920	2,244	32,164	70,080	67,836	(3.2)
(8) 200,000	151,000	77,640	5,823	83,463	122,360	116,537	(4.8)
(9) 500,000	382,000	238,380	17,879	256,259	261,620	243,741	(6.8)

(a) Surtax did not apply to families with less than $293 in income tax liability.

As shown, this across-the-board tax increase had the effect of reducing aftertax income by a much greater percentage for high-income taxpayers than for low-income taxpayers. For example, aftertax income for the $200,000 bracket was reduced by (4.8)% which was six times the (0.8)% reduction absorbed by the $15,000 bracket. Again, under any progressive tax system, the true effect of a tax cut is measured by the percent reduction in taxes paid, not by percent increases in aftertax income.

A third negative argument used against the Reagan tax proposal is that the higher income brackets get a proportionately greater break than lower income brackets in 1984 under the Reagan plan as compared with 1980 under current law, as seen in the following:

(Table follows)

1980 AND 1984 AVERAGE TAX RATES

		(1)	(2)	(3)	(4)
			Average Tax Rates		
	1980 Gross Income	Same Income 1984 Dollars	1980 Current Law	1984 Reagan Plan	% 1984 Reagan Plan (Under)/Over 1980 Current Law
(1)	$ 10,000	$13,500	3.7%	5.1%	37.8%
(2)	20,000	27,000	10.7	9.4	(12.1)
(3)	30,000	40,500	13.9	12.4	(10.8)
(4)	50,000	67,500	19.9	17.9	(10.1)
(5)	100,000	135,000	29.4	25.2	(14.3)

It is fallacious to compare 1984 under the Reagan plan with 1980 under current law as 1984 includes the effect of tax bracket creep. As can be seen from the preceding, in this kind of comparison the higher tax bracket gets more of a reduction than the lower tax bracket for the simple reason that inflation is pushing everyone into higher brackets. Thus, it is inflation which is being measured, not the tax reduction.

The correct way to measure the effect of the proposed tax reduction is to compare the 1984 tax rates under present law with the 1984 tax rates under the Reagan plan as follows:

(Table follows)

COMPARISON OF TAX RATES UNDER
CURRENT LAW AND UNDER REAGAN PLAN
AT 1984 AVERAGE TAX RATES

	(1)	(2)	(3)	(4)	(5)
	1980 Taxable Income	Same Income 1984 (Inflated)*	Under Present Law	Under Reagan Plan	Reagan Law % Under Present Law
(1)	$ 10,000	$ 13,5[illegible]	18.4 %	13.2 %	[illegible]
(2)	20,000	27,000	23.7	17.2	(27.4)
(3)	30,000	40,500	29.4	21.6	(26.5)
(4)	50,000	67,500	37.2	27.9	(25.0)
(5)	100,000	135,000	43.6	36.0	(17.4)

62% Greater Tax Rate Cut

* Assuming 35% inflation between 1980 and 1984 -- 7.8% average annual.

As compared with present law, the Reagan proposal would grant every income level a tax-rate reduction. And even allowing for tax-bracket creep, which clearly hurts lower-income brackets, the largest percent reductions in 1984 would go to the lowest incomes -- 62 percent more for the $10,000 taxable income earner than for those in the $100,000 bracket.

The preceding chart is based on total taxable income, including unearned as well as earned. The following compares the proposed Reagan marginal tax rates with current law for earned income:

(Table follows)

COMPARISON OF PROPOSED REAGAN
MARGINAL TAX RATES WITH CURRENT LAW
Wage and Salary Income

		(1)	(2)	(3)	(4)	
	Constant 1980 $ Taxable Income	1984 Marginal Tax Rates*		Reagan Plan (Under) Current Law		
		Current Law	Reagan Plan	Amount	%	
(1)	$ 10,000	24 %	18 %	(6)%Pts.	(25.0)%	Average (23.7)%
(2)	20,000	37	27	(10)	(27.0)	
(3)	30,000	49	36	(13)	(26.5)	
(4)	40,000	50	40	(10)	(20.0)	
(5)	50,000	50	40	(10)	(20.0)	vs.
(6)	100,000	50	47	(3)	(6.0)	Average (2.0)%
(7)	200,000	50	50	-	-	
(8)	500,000	50	50	-	-	

* Assuming 10% per year inflation.

How can anyone say the Reagan proposals are "less progressive"?

Taxable wage and salary income at the $100,000 level gets a reduction in 1984 under the Reagan plan versus current law of only (6.0)%. This compares with an average reduction of (23.7)% for incomes of $50,000 and under. Clearly the Reagan proposal makes the tax structure more progressive, not less.

An area of our tax structure that has been particularly adverse to investment, production and growth is the capital gains tax. This tax was raised in successive steps from 25% in 1968 to 49.1% until it was reduced to 28% in October 1978. The relationship between the capital gains tax and economic performance can be seen in the following:

(Table follows)

THE DISINCENTIVIZATION OF AMERICA

	(1)	(2)	(3)	(4)	(5)
	1962 - 1980				1980 Maximum Capital Gains Tax
	Average Investment As % Of GNP	Government Spending As % Of GNP (a)	Real GNP (Avg. Ann.	Productivity % Increase)	
(1) Japan	32.5 %	8.7 %	7.9 %	7.8 %	0 %
(2) Belgium	21.5	15.0	3.9	6.6	0
(3) Netherlands	23.6	16.8	4.1	6.4	0
(4) Italy	20.6	15.4	4.1	5.6	0
(5) France	22.9	13.8	4.4	5.4	0
(6) Germany	20.6	17.5	3.6	5.2	0
(7) United Kingdom	18.4	18.7	2.3	2.7	30.0 %(b)
(8) United States	17.8	20.6	3.5	2.2	28.0

Japan Versus U. S.

83%	Higher Investment Rate
58%	Lower Gov't Expenditures
126%	Higher GNP Growth
3.5X	Productivity Growth

(a) Federal, State and Local Current Spending Excluding Transfer Payments and Capital Spending.

(b) Applies to both Short-Term and Long-Term Gains.

This chart is a repeat of an earlier one with, however, the last column added to show that the countries with the highest economic performance have had no Capital Gains Tax while the U. K. and U. S. having rates of 30% and 28%, respectively, have had correspondingly poor performance.

There is evidence of the beneficial effect from the reduction in the capital gains tax in the following on new equity issues by small companies.

(Table follows)

EQUITY CAPITAL RAISED BY COMPANIES
HAVING A NET WORTH OF UNDER $5 MILLION
(Millions of $)

	Year	(1) No. of Offerings	(2) Funds Raised: Current $	(3) Funds Raised: Constant 1980 $	(4) Maximum Capital Gains Tax Rate
(1)	1968	358	$ 745.3	$ 1,643.3	25.0 %
(2)	1969	698	1,366.9	2,869.5	25.0
(3)	1970	198	375.0	747.3	29.5
(4)	1971	248	550.9	1,044.5	40.0
(5)	1972	409	896.0	1,631.2	45.0
(6)	1973	69	159.7	274.8	45.0
(7)	1974	9	16.1	25.3	45.0
(8)	1975	4	16.2	23.2	45.0
(9)	1976	29	144.8	197.0	49.1
(10)	1977	13	42.6	54.8	49.1
(11)	1978	21	89.3	106.9	49.1
(12)	1979	46	182.9	201.1	28.0
(13)	1980	135	821.5	821.5	28.0
		Up By 542.9%	Up By 819.9%		
			Up By 4,987%	Up By 3,288%	

DURING THE FIRST QUARTER OF 1981 THERE WERE 59 NEW OFFERINGS TOTALLING $313 MILLION, OR MORE THAN THE 5-YEAR TOTAL FOR 1974 THROUGH 1978.

Equity capital raised by companies having a net worth of under $5 million increased from $89.3 million in 1978 to $821.5 million in 1980, an increase of about 820%. This resulted from an increase in the number of offerings from 21 in 1978 to 135 in 1980, the second year of the reduced maximum Capital Gains Tax rate. During the First Quarter of 1981, there were 59 new offerings totaling $313 million, or more than the five-year total for 1974 through 1978.

It is most important to increase capital formation in small companies as they account for the bulk of new jobs, as seen in the following:

(Table follows)

NET NEW JOBS CREATED
BY SIZE OF FIRM, 19[illegible]

		(1)	(2)	(3)	(4)	(5)
	Number of Employees In Each Firm	Northeast	Midwest	West	South	Total United States
(1)	20 or Fewer	727,77[illegible]	1,1[illegible],154	[illegible]	1,5[illegible]	[illegible]
(2)	21 - 50	26,55[illegible]	201,421	238,717	322,8[illegible]	[illegible]9,5[illegible]
(3)	51 - 100	(71,588)	87,876	113,909	1[illegible]5,800	28[illegible]
(4)	101 - 500	(136,629)	51,781	167,214	[illegible],535	35[illegible]
(5)	501 +	(135,219)	208,050	239,459	585,[illegible]	897,581
(6)	Total	410,890	1,674,282	[illegible],300,112	2,873,519	6,758,9[illegible]3
		As % Of Total New Jobs				
(7)	20 or Fewer	177.1 %	67.2 %	59.5 %	52.5 %	66.0 %
(8)	21 - 50	6.5	12.0	11.6	11.2	11.2
(9)	51 - 100	(17.4)	5.2	6.3	5.5	4.3
(10)	101 - 500	(33.3)	3.1	9.3	9.4	5.2
(11)	501 +	(32.9)	12.4	13.3	20.4	13.3

81.5 % IN FIRMS OF 100 EMPLOYEES OR FEWER

During the period 1969-1976, 81.5% of net new jobs created in the U.S. were accounted for by firms having 100 employees or fewer. 66.0% of the new jobs were created by firms with 20 or fewer employees. The smaller companies are the ones that need capital and that will benefit most from a reduction of the capital gains tax.

While the reduction in the maximum capital gains tax to 28% has a favorable effect on capital formation, it is still a very burdensome tax in an inflationary time, as seen in the following:

(Table follows)

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REAL AFTER TAX RETURN ON CAPITAL GAINS OVER
AVERAGE 7.2 YEAR HOLDING PERIOD

		(1)	(2)	(3)	(4)	(5)
	Period Of Time	Annual Inflation Rate	Capital Gains Tax Rate	Double Your Money Back, Nominal Pretax	Triple Your Money Back, Nominal Pretax	Triple Your Money Back, Nominal Pretax Avg. Ann. %
(1)	1950's Avg.	2.0%	25.0%	52.1%	116.2%	11.3%
(2)	1960's Avg.	2.3	25.0	49.1	112.0	11.0
(3)	1978	5.2%	49.1%	4.4%	40.2%	4.8%
(4)	1979	11.3	28.0	(20.3)	12.9	1.7
(5)	1980	13.5	28.0	(30.9)	(2.0)	(0.3)
(6)	Future?	18.0%	20.0%	(45.1)%	(20.9)%	(3.2)%
(7)	Future?	16.0	20.0	(38.4)	(11.0)	(1.6)
(8)	Future?	14.0	20.0	(29.8)	1.4	0.2
(9)	Future?	12.0	20.0	(20.3)	15.3	2.0
(10)	Future?	10.0	20.0	(9.4)	30.9	3.8
(11)	Future?	8.0	20.0	3.7	49.1	5.7

As brought out, under the inflationary conditions of 1980, if one tripled the pretax value of an investment in the 7.2 years that equity investments are held on average, with a 28% capital gains tax, that would still be a loss of (2.0)% on the initial investment.

Further, even with a reduction in the maximum capital gains tax to 20%, with inflation at 10%, pretax doubling of an initial investment over a period of 7.2 years would result in a loss of (9.4)% after tax.

It is interesting to consider the effect of eliminating the capital gains tax completely, estimated in the following for a five-year period ending in 1985:

(Table follows)

EFFECT OF ZERO CAPITAL GAINS TAX IN FIVE YEARS, 1985

AN ECONOMIC SHOT IN THE ARM

	(1)	(2)	(3)	(4)
	If No Change In Capital Gains Tax	If Zero Capital Gains Tax	Economic Gain From Zero Capital Gains Tax	
			Amount	%
(1) GNP (Billions of Current $)	$ 4,418.3	$ 4,893.5	$ 475.2	10.8 %
(2) Business Fixed Investment (Billions of Current $)	478.2	570.2	92.0	19.2
(3) Personal Consumption (Billions of Current $)	2,718.3	3,042.9	324.6	11.9
(4) Federal Budget Surplus (Billions of Current $)	16.0	122.6	106.6	666.2
(5) New Jobs Created, 1981-85 (Millions)	6.7	8.2	1.5	22.4
(6) S&P Stock Index (1941-43=10)	161.54	193.85	32.31	20.0

5.7% more than the entire 1959 GNP

Record federal surplus in 1985 would make further cuts in personal and corporate taxes possible.

It has been estimated that elimination of the capital gains tax would result in $475.2 billion additional GNP or an increase of 10.8% in 1985. The gain would feed into higher federal revenue and a higher federal budget surplus, estimated at $106.6 billion, which could be used to make further cuts in personal and corporate taxes.

It is difficult to understand why there have been doubts in the past as to the negative effects of capital gains taxes. In addition to the evidence already presented it is of interest to consider relative performance among the Lower 48 States having varying tax rates, as follows:

(Table follows)

CAPITAL GAINS TAXES AND INCOME GROWTH

Lower 48 States Ranked in Four Groups on Basis of Income Growth

	Average of:	(1) Real Personal Income Avg. Ann. % Increase 1972-1979	(2) 1979 Maximum Tax Rate on Capital Gains	(3) 1979 Total Taxes as % of Income
(1)	Top Twelve WY, NV, TX, NM, WA, OK, AZ, OR, UT, ID, LA, CO	5.1%	1.6%	15.2%
(2)	Second Twelve FL, AR, NH, CA, KY, SC, AL, KS, TN, WV, VA, MN	3.4	2.9	14.8
(3)	Third Twelve MS, IA, MT, GA, NC, WI, ME, NE, IN, MO, ND, VT	2.5	3.7	14.8
(4)	Lowest Twelve MI, SD, IL, MD, OH, CT, PA, DE, RI, MA, NJ, NY	1.2	3.9	16.0
	Memo: New York State	(0.4)%	10.9%	17.1%
	Memo: Total New York State and City		14.5%	

As brought out, the 12 states with the highest rate of growth in personal income during 1972-1979, averaging 5.1% per year, had the lowest maximum capital gains tax rates, averaging 1.6%. By comparison, the 12 states with the smallest increase in personal income during the years 1972-1979, at 1.2% per annum, had the highest maximum capital gains tax rate, averaging 3.9%.

It is notable that the State of New York, with the highest maximum capital gains tax rate of all the states, was the only state to experience a decrease in total real personal income in 1972-1979, at (0.4)% per annum.

The experience of the states and countries having steep capital gains taxation provides strong support for entirely eliminating this tax.

In summary, with respect to taxation, I urge the following:

1. CUT THE TOP PERSONAL TAX RATE TO 36%.

2. ADJUST ALL PERSONAL AND CORPORATE EARNINGS FOR INFLATION BEFORE TAXING.

3. ELIMINATE THE CAPITAL GAINS TAX COMPLETELY.

CHARTS TO ACCOMPANY TESTIMONY OF

MR. J. PETER GRACE
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
W.R. GRACE & CO.

Before the

SENATE FINANCE COMMITTEE

Washington, D.C.
May 19th, 1981

CHART 1

10% INFLATION TAX BRACKET CREEP

PRETAX INCOME REQUIRED FOR A FAMILY OF FOUR TO MAINTAIN 1972 REAL PURCHASING POWER

	(1)	(2)	(3)	(4)
(1) 1972	$ 20,000	$ 30,000	$ 40,000	$ 50,000
(2) 1980	41,080	63,586	86,767	108,956
(3) 1986	76,320	119,962	160,876	198,929
(4) 1993	166,337	253,182	332,931	406,889

CHART 2

10% INFLATION TAX BRACKET CREEP WITH NO INCREASE IN PURCHASING POWER (Wage and Salary Income)

	(1)	(2)	(3)	(4)	(5)
	1972 Taxable Income	1972	1980	1986	1993
		Marginal Tax Rates			
(1)	$10,000	19.0%	24.0%	32.0%	50.0%
(2)	15,000	22.0	28.0	43.0	50.0
(3)	20,000	25.0	37.0	50.0	50.0
(4)	25,000	28.0	43.0	50.0	50.0
(5)	30,000	32.0	49.0	50.0	50.0
(6)	40,000	36.0	50.0	50.0	50.0
(7)	50,000	42.0	50.0	50.0	50.0
(8)	100,000	50.0	50.0	50.0	50.0

CHART 3

KEMP-ROTH[a] VS. BRACKET CREEP
(Billions of Current $)

		(1)	(2)	(3)	(4)
			Bracket Creep Increase		
		Income Tax Reduction	Amount	As % Of Tax Reduction	Inflation Rate (GNP Deflator)
(1)	1981	$(14.6)	$ 8.9	61.0%	9.1%
(2)	1982	(48.7)	31.5	64.7	10.4
(3)	1983	(92.9)	57.0	61.3	9.1
(4)	1984	(129.8)	87.5	67.4	8.5
(5)	1985	(152.8)	123.6	80.9	8.1
(6)	1986	(178.9)	166.1	92.9	7.5
(7)	Cumulative Six-Year Total	$(617.7)	$474.6	76.8%	65.7% (b)
				Avg. Ann.	8.8%

(a) Assumed effective July 1, 1981.
(b) Compounded

CHART 4

THE DISINCENTIVIZATION OF AMERICA

	(1)	(2)	(3)	(4)	(5)
	1962 - 1980				
	Average Investment As % Of GNP	Government Spending As % Of GNP (a)	Real GNP (Avg. Ann. % Increase)	Productivity (Avg. Ann. % Increase)	1980 Maximum Capital Gains Tax
(1) Japan	32.5%	8.7%	7.9%	7.8%	0%
(2) Belgium	21.5	15.0	3.9	6.0	0
(3) Netherlands	23.6	16.8	4.1	6.4	0
(4) Italy	20.6	15.4	4.1	5.6	0
(5) France	22.9	13.6	4.4	5.4	0
(6) Germany	20.6	17.5	3.6	5.2	0
(7) United Kingdom	18.4	18.7	2.3	2.7	30.0%(b)
(8) United States	17.8	20.6	3.5	2.2	28.0

Japan Versus U.S.

83%	Higher Investment Rate
58%	Lower Gov't Expenditures
126%	Higher GNP Growth
3.5X	Productivity Growth

(a) Federal, State and Local Current Spending Excluding Transfer Payments and Capital Spending.

(b) Applies to both Short-Term and Long-Term Gains.

CHART 5

U.S.'s DECLINING SHARE OF WORLD OUTPUT
(Percent of World GNP)

	(1)	(2)	(3)	(4)	(5)
	1953	1960	1970	1980	1980 As Multiple Of 1953
(1) Japan	3.9%	5.1%	8.8%	10.1%	2.6X
(2) LDC's	20.7	18.7	18.2	21.9	1.1
(3) France	5.2	5.5	5.6	5.5	1.1
(4) West Germany	7.0	8.7	8.2	7.3	1.0
(5) EEC	25.2	26.9	25.4	22.9	0.9
(6) U.S.	31.4	28.0	24.6	22.8	0.7
(7) U.K.	6.3	5.8	4.6	3.7	0.6

CHART 6

TAXES ON INVESTMENT RETARD SAVINGS AND PRODUCTIVITY IN THE U.S.

	(1) 1979 Tax Rate On Investment Income (a)	(2) Savings Rate, 1975-1979	(3) Avg. Ann. % Increase In Output Per Hour, 1973-1978
(1) France	7.3%	17.2%	3.9%
(2) W. Germany	11.8	14.5	3.9
(3) Japan	14.4	21.5	3.4
(4) Canada	30.0	10.3	1.1
(5) United Kingdom	32.5	12.2	2.2
(6) United States	33.5	6.3	1.0

(a) $10,000 dividends, $5,000 interest and $34,000 capital gains coupled with $50,000 salary.

CHART 7

THE HIGH COST OF DYING

Death and Gift Taxes as a Percent of Gross Domestic Product

	(1) Percent	(2) U.S. % As A Multiple Of Each	
United States	0.42%	1.00X	
United Kingdom	0.32	1.31	
Belgium	0.30	1.40	
Switzerland	0.23	1.83	
Ireland	0.21	2.00	
Japan	0.19	2.21	
France	0.18	2.33	◄ France
Denmark	0.18	2.33	
Netherlands	0.18	2.33	
Luxembourg	0.14	3.00	
Portugal	0.13	3.23	
Spain	0.13	3.23	
Sweden	0.11	3.82	
Finland	0.10	4.20	
Germany	0.09	4.67	◄ Germany
Canada	0.07	6.00	
Norway	0.07	6.00	
Italy	0.07	6.00	◄ Italy
Austria	0.06	7.00	

CHART 8

WHERE DOES A FAMILY'S MONEY GO?
Family Of Four With 1971 Income Of $16,000

	(1)	(2)	(3)	(4)
	% Of Total Spending			
	1971	1975	1980	% Inc./(Dec.) 1980 vs. 1971
(1) Taxes on Income	19.1%	22.3%	27.7%	45.0%
(2) Food	20.1	21.6	20.4	1.5
(3) Transportation	7.9	7.4	8.0	1.3
(4) Medical Care	4.0	3.8	4.0	•
(5) Housing	25.0	24.0	22.5	(10.0)
(6) Personal Care	2.3	2.1	1.9	(17.4)
(7) Other	13.0	11.5	10.0	(23.1)
(8) Clothing	8.6	7.3	5.5	(36.0)
(9) Total	100.0%	100.0%	100.0%	

To The Government

CHART 9

COSTS OF REDUCING MAXIMUM TAX RATE ON PERSONAL INCOME, 1980

		(1)	(2)	(3)	(4)
			Loss Of Revenue By Reducing From 70%		
	Maximum Tax Rate	Income Tax Generated (Billion $)	Amount (Billion $)	% Of $579.6 Billion Budget	% Increase In Income Required To Offset Lost Tax Revenues
(1)	70%	$244.1	•	•	•
(2)	60	242.9	$ 1.2	0.2%	0.3%
(3)	50	240.7	3.4	0.6	0.9
(4)	45	234.1	10.0	1.7	2.7
(5)	42	230.9	13.2	2.3	3.5
(6)	36	221.6	22.5	3.9	6.0

Underground Economy — $250 Billion

Lost Taxes — 30 Billion

Equal To:

8.8X Revenue loss at a 50% maximum tax rate

1.3X Revenue loss at a 36% maximum tax rate

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CHART 10

COMPARISON OF TAX RATES UNDER CURRENT LAW AND UNDER REAGAN PLAN AT 1984 AVERAGE TAX RATES

	(1) 1980 Taxable Income	(2) Same Income 1984 Dollars*	(3) Under Present Law	(4) Under Reagan Plan	(5) Reagan Law % (Under) Present Law	
(1)	$ 10,000	$ 13,500	18.4%	13.2%	(28.3)%	62% Greater Tax Rate Cut
(2)	20,000	27,000	23.7	17.2	(27.4)	
(3)	30,000	40,500	29.4	21.6	(26.5)	
(4)	50,000	67,500	37.2	27.9	(25.0)	
(5)	100,000	135,000	43.6	36.0	(17.4)	

*Assuming 35% inflation between 1980 and 1984 -- 7.8% average annual.

CHART 11

REAL AFTER TAX RETURN ON CAPITAL GAINS OVER AVERAGE 7.2 YEAR HOLDING PERIOD

	Period Of Time	(1) Annual Inflation Rate	(2) Capital Gains Tax Rate	(3) Double Your Money Back, Nominal Pretax	(4) Triple Your Money Back, Nominal Pretax	(5) Triple Your Money Back, Nominal Pretax Avg. Ann. %
(1)	1950's Avg.	2.0%	25.0%	52.1 %	116.2 %	11.3 %
(2)	1960's Avg.	2.3	25.0	49.1	112.0	11.0
(3)	1978	5.2%	49.1%	4.4 %	40.2 %	4.8 %
(4)	1979	11.3	28.0	(20.3)	12.9	1.7
(5)	1980	13.5	28.0	(30.9)	(2.0)	(0.3)
(6)	Future?	18.0%	20.0%	(45.1)%	(20.9)%	(3.2)%
(7)	Future?	16.0	20.0	(38.4)	(11.0)	(1.6)
(8)	Future?	14.0	20.0	(29.5)	1.4	0.2
(9)	Future?	12.0	20.0	(20.3)	15.3	2.0
(10)	Future?	10.0	20.0	(9.4)	30.9	3.8
(11)	Future?	8.0	20.0	3.7	49.1	5.7

CHART 12

NET NEW JOBS CREATED BY SIZE OF FIRM, 1969-1976

	Number of Employees In Each Firm	(1) Northeast	(2) Midwest	(3) West	(4) South	(5) Total United States
(1)	20 or Fewer	727,771	1,125,154	1,070,803	1,536,087	4,459,815
(2)	21 - 50	26,555	201,421	208,717	322,816	759,509
(3)	51 - 100	(71,588)	67,876	113,909	158,800	288,997
(4)	101 - 500	(136,629)	51,781	167,214	270,835	353,201
(5)	501 +	(135,219)	208,050	239,469	585,081	897,381
(6)	Total	410,890	1,674,282	1,800,112	2,873,619	6,758,903

As % Of Total New Jobs

		(1) Northeast	(2) Midwest	(3) West	(4) South	(5) Total United States
(7)	20 or Fewer	177.1 %	67.2%	59.5%	53.5%	66.0%
(8)	21 - 50	6.5	12.0	11.6	11.2	11.2
(9)	51 - 100	(17.4)	5.2	6.3	5.5	4.3
(10)	101 - 500	(33.3)	3.1	9.3	9.4	5.2
(11)	501 +	(32.9)	12.4	13.3	20.4	13.3

81.5% IN FIRMS OF 100 EMPLOYEES OR FEWER

CHART 13

EQUITY CAPITAL RAISED BY COMPANIES HAVING A NET WORTH OF UNDER $5 MILLION (Millions of $)

	(1)	(2)	(3)	(4)
		Funds Raised		Maximum Capital Gains Tax Rate
Year	No. of Offerings	Current $	Constant 1980 $	
(1) 1968	358	$ 745.3	$1,643.3	25.0%
(2) 1969	698	1,366.9	2,869.5	25.0
(3) 1970	198	375.0	747.3	29.5
(4) 1971	248	550.9	1,044.5	40.0
(5) 1972	409	896.0	1,631.2	45.0
(6) 1973	69	159.7	274.8	45.0
(7) 1974	9	16.1	25.3	45.0
(8) 1975	4	16.2	23.2	45.0
(9) 1976	29	144.8	197.0	49.1
(10) 1977	13	42.6	54.8	49.1
(11) 1978	21	89.3	106.9	49.1
(12) 1979	46	182.9	201.1	28.0
(13) 1980	135	821.5	821.5	28.0

Up By 3,288%

DURING THE FIRST QUARTER OF 1981 THERE WERE 59 NEW OFFERINGS TOTALLING $313 MILLION, OR MORE THAN THE 5-YEAR TOTAL FOR 1974 THROUGH 1978.

CHART 14

WHERE DID THE PERSONAL INCOME TAX MONEY COME FROM IN 1980?

	Expanded Income Level		(1) % Of Total Taxpayers	(2) % Of Total Taxable Income	(3) % Of Total Taxes Paid	(4) Ratio Of % Taxes To % Income	(5) Taxes Paid As % Of $579.6 Billion Budget
(1)	$0-$14,999		50.9%	21.9%	10.7%	0.5X	4.5%
(2)	$100,000 +		0.9	6.8	16.0	2.4	6.7
(3)		Subtotal	51.8	28.7	26.7	0.9	11.2
(4)	$50,000-$99,999		3.8	8.8	13.3	1.5	5.6
(5)		Subtotal	55.6	37.5	40.0	1.1	16.8
(6)	$15,000-$49,999		**44.4**	**62.5**	**60.0**	1.0	25.3
(7)		Total	100.0%	100.0%	100.0%	1.0X	42.1%
					Social Security Tax		27.7
					Business Taxes		11.2
					Other Revenue		8.7
					Deficit		10.3
					Total		100.0%

Underground Economy	$250 Billion
Lost Taxes	30 Billion

Equal To:

- 5% of the Federal Budget
- 77% of taxes paid by the $100,000 + income brackets (0.9% of all taxpayers)
- 115% of taxes paid by the under $15,000 income brackets (50.9% of all taxpayers)

CHART 15

RECOMMENDATIONS

1. CUT THE TOP PERSONAL TAX RATE TO 36%.
2. ADJUST ALL PERSONAL AND CORPORATE EARNINGS FOR INFLATION BEFORE TAXING.
3. ELIMINATE THE CAPITAL GAINS TAX COMPLETELY.

The CHAIRMAN. That's probably a good thing. [Laughter.]
I think, you have a conference luncheon at 12:30.
Senator BRADLEY. Yes, we do.
The CHAIRMAN. How long will that last?
Thank you very much; this panel is excused.
I suggest we recess until the hour of 2 and the panel then will be Mr. Dunn, Mr. O'Connell, and Mr. Smith. We ought to have good attendance this afternoon.
[Whereupon, at 12:30 p.m., the hearing recessed, to reconvene at 2 p.m., the same day.]
The CHAIRMAN. If the panel of Mr. Dunn, Mr. O'Connell, and Mr. Smith are still in town we'll now hear you.
I would say in as friendly way as I can, we still have 5 panels of 20-some witnesses, and I apologize for not moving more quickly this morning, but I can stay until 8 this evening.

STATEMENT OF G. KENNETH CHRISTRUP, DIRECTOR OF TAXES, XEROX CORP.

Mr. CHRISTRUP. Stu Dunn is counsel to the Rochester Tax Council. I'm a member of the Rochester Tax Council and former chairman, and in view of Dr. Thurow's comments about getting rid of the tax councils and lawyers and tax accountants, I decided to testify myself instead of having Stu Dunn testify.
Mr. Chairman, my name is Kenneth Christrup. I'm director of taxes of Xerox Corp. I'm appearing before you today on behalf of the Rochester Tax Council, an organization of companies having strong affiliation with the Rochester, N.Y., area.
The companies include Corning Glass, Eastman Kodak, Gannett Press, Sybron, and Xerox Corp., among others.
While the member companies are engaged in a variety of businesses, including communications and banking, most of the member countries are engaged in the manufacture and sale of high technology products throughout the world.
In summary, the council supports S. 683 in its entirety, subject to certain technical corrections.
The council has long been on record as strongly supporting the so-called 10-5-3 depreciation bill introduced in the last Congress by Senator Danforth. While we prefer S. 1597, we support this bill since much of the machinery and equipment of the member companies already qualifies for useful depreciation lives that are equal to or not significantly greater than the 10-5-3 lives under ACRS. This support is not based primarily on the direct benefit that most of the members of the council would receive from this legislation.
Rather, we primarily base our support on the conviction that this legislation will accomplish its goals of stimulating substantial capital investment by business. We also believe that it will simplify recordkeeping in the expensive system under the present ADR system and will litigate against disputes with the Internal Revenue Service.
We wish to bring to your attention some important technical problems in S. 683 which need correction.
First, and most important to us is the calculation of earnings and profits for foreign subsidiaries under section 207 of the bill. Section 207 provides a generally mandatory rule roughly doubling lives

allowable under ACRS and limiting methods of straight line for earnings and profits purposes.

This mandatory rule for determining the amount of the depreciation deduction in calculating earnings and profits applies to foreign, as well as domestic corporations. The application to foreign corporations has the consequence, apparently unintended, of reducing the amount of indirect tax credits presently available to U.S. corporations.

In the case of companies that have relatively short life machinery and equipment in their foreign subsidiaries—for example, computers and copiers, in their foreign subsidiaries. The tax increase can be and generally would be enormous.

For example, one of the members of the Rochester Tax Council estimates that if ACRS had been in full force in 1979—a relatively typical year for that company—the tax savings resulting from the system through its operations in the United States would be considerably more than offset by decreased foreign tax credits due to this extension of lives and elimination of rapid depreciation in calculating earnings and profits of the foreign subsidiaries under section 902.

We wish to make it clear that this problem is not caused by the administration's policy decision to limit the benefits of ACRS to depreciable property predominantly used within the United States.

This understandable policy decision, while denying the benefits of the system to assets located outside the United States, would not deprive taxpayers of using present rules to calculate depreciation on such assets.

Happily, responsible Treasury Department officials have informally indicated that they also support technical revision of the bill to remove the inequity found in section 207.

This can be simply and directly accomplished by following the precedent which Congress established in 1972 when it provided relief for the earnings and profits of foreign corporations in any taxable year in which it had done its business primarily outside of the United States.

We would welcome the opportunity to work with the staff of the committee, the joint committee staff, and the Treasury Department in reaching an acceptable resolution of this serious technical flaw.

The second technical problem that concerns us is closely related to the first one. S. 683 would generally require that gain or loss be recognized on the disposition of recovery property.

Again, our concern is with the impact of this rule on the foreign tax credit calculations under section 902.

As in the case of depreciation of foreign assets, the equitable and simple resolution of this technical problem is to continue the present system for determining gain or loss and the disposition of depreciable property.

The bill includes tangible section 1245 property——

The CHAIRMAN. We are going to try to stick to our bells, so that you want to conclude here in about 30 seconds.

Mr. CHRISTRUP. Yes, I can do that.

We recommend leaving research property in the 5-year category. We believe that research and development can best be stimulated

in the United States by early passage of a bill similar to H.R. 2473 and urge that a comparable bill be introduced in the Senate.

Thank you for the opportunity of expressing the views of the Rochester Tax Council.

The CHAIRMAN. Thank you. Mr. O'Connell.

STATEMENT OF MR. DANIEL K. O'CONNELL, EXECUTIVE VICE PRESIDENT, RYDER SYSTEM, INC.

Mr. O'CONNELL. Yes, Mr. Chairman. Thank you for the opportunity to present the views of Ryder Systems.

I am executive vice president of Ryder. Our basic business is full service truck leasing and rental. Our power equipment can be depreciated over a 3-year period under the existing law.

We normally replace it in 3½ to 4 years. Accordingly, we are particularly concerned about the affect of cost recovery tax legislation on productive assets with shorter replacement cycles. Assets such as trucks, computers, office equipment, and farm machinery.

We support the levels of investment tax credit and the related recapture provisions that are incorporated in the administration's capital cost recovery proposals. And, I am not here to advocate any changes in those proposals.

However, we are aware of alternative proposals designed to limit tax benefits, so that the combined present value of the tax benefits from depreciation and investment tax credits would not be greater than the tax benefits from immediate expensing.

Those alternative proposals so far, have attempted to meet this goal by cutting back investment tax credits, rather than depreciation for shorter lived assets.

If such a limit is needed, we urge you to limit the depreciation rather than the investment tax credit.

For example, if a 2-4-7-10 cost recovery approach were desired similar to this committee's 1980 bill, the 2- and 4-year classes would be limited to straightline depreciation. This would permit allowance of a full 10-percent credit for the 4-year class and a 5-percent credit for the 2-year class and remaining then within the limitation.

Or, if a 3-5-7-10 approach were used, the 3- and 5-year classes would be limited to the use of 150 percent declining balance depreciation and the investment tax credit provisions would be exactly those contained in the administration's capital cost recovery program.

Again, this would keep that program within the limitation sought.

It is essential that we recognize this special incentive affect of the investment tax credit, compared to depreciation. A dollar of investment tax credit has a greater incentive effect than a dollar of tax savings from accelerated depreciation. Even if the two are equivalent on the basis of the present value of cash flows.

This is so, because the investment tax credit must be reported as a reduction in tax liability for financial reporting purposes, thereby increasing net after tax earnings.

On the other hand, the tax reduction attributable to the excess of tax depreciation over book depreciation must be shown as a de-

ferred tax liability and accordingly it is not reflected as an increase in the firm's after tax net income.

We believe that no corporation's investing in shorter lived assets would prefer faster depreciation allowances to investment tax credit if it were forced to choose between the two.

However, such an alternative could be provided for on an elective basis.

Also, in the event that several cost recovery periods are specified with differing rates of investment tax credit, such as the 2-4-7-10 plan, we strongly urge that a taxpayer himself be permitted to choose between greater depreciation and greater investment tax credit.

This can be done simply by allowing him to elect a longer recovery period to obtain a greater investment tax credit.

Finally, any investment tax credit recapture provisions should be graduated at intervals no greater than 1 year to minimize distortion of equipment replacement decisions.

The graduated approach greatly lessens any inclination to retain an asset beyond the time that it would otherwise economically make sense to replace it. The graduated approach is included in the administration's proposal and it's adaptable to any cost recovery program that you may choose to adopt.

Thank you.

The CHAIRMAN. Thank you, and I might say in advance that your entire statement is being made a part of the record. Mr. Smith.

STATEMENT OF JAMES E. SMITH, PRESIDENT OF CHARLS E. WALKER ASSOCIATES, INC.

Mr. SMITH. Thank you, Mr. Chairman. My name is Jim Smith. I am president of Charls Walker Associates. I am appearing this afternoon on behalf of 20 companies engaged in primary metals production, mining and rail transportation who are petitioning this committee in the Congress to consider repeal of the corporate minimum tax.

The CHAIRMAN. Your time's not quite up. [Laughter.]

Mr. SMITH. Thank you.

The corporate minimum tax is not a particularly well-known provision of the Tax Code. It was adopted in 1969 in the Tax Reform Act, and if I could take just a moment to refresh your recollections as to how it operates.

A corporation which has preference item treatment, the two principal items being percentage depletion and the untaxed portion of capital gains aggregate those preference items for any particular tax year and they are then contrasted with the corporation's regular corporate tax liability.

To the extent that the preference items exceed the regular corporate tax liability, a flat 15-percent tax is additionally assessed on that corporation. It is a add on tax and it is a flat rate tax.

Repeal of the minimum tax in our opinion is particularly relevant to this committee's consideration of the administration's program for accelerated capital cost recovery. Because for every dollar of tax benefit that you achieve for a corporation impacted by the minimum tax through capital cost recovery, which reduces their

regular corporate tax, you expose a dollar of preference which is taxed at 15 percent.

Thus, for these companies impacted by the minimum tax, they are getting 85 percent of the benefit that other companies are getting from tax provisions designed to incentivize capital investment.

It seems to me that in testing the efficacy of any particular tax provision, there are certainly two tests that are predominant.

One, the capacity of the tax provision to generate revenue, and second, what I call the equity quotient. Does the tax apply fairly, and even-handedly? It seems to me on both of these tests, the corporate minimum tax gets at best a D and perhaps a flunking grade.

In terms of income tax generation in 1977, the last year for which we have actual figures, the corporate minimum tax generated $267 million of tax revenue contrasted with $56 billion from the regular corporate tax. We estimate that in 1981, there will be about $370 million in corporate minimum tax liabilities.

In terms of equity, the corporate minimum tax has its greatest incidence when companies are experiencing low profitability. Easy to understand, low profitability, lower regular corporate taxes, more of the preference items exposed at a tax of 15 percent.

Two practical examples that seem to me to point up the anomaly of this tax. A company that has a net operating loss, I think we might all agree ought to have no tax liability in that year. But if it has preference items it gets every dollar of those preference items taxed at 15 percent.

One of our clients had a gigantic loss in 1977, not only had the corporate minimum tax triggered in that year, but in the 3 preceding years, because of the carryback.

Another example, take two companies, identically situated. Both the same levels of income, both the same levels of preference, both moving into a period of declining profitability. Regular tax is still exceeding preferences, so no corporate minimum tax applies.

Company A in trying to stop its drift into unprofitability, engages in a big capital expenditure program reduces it regular tax by the investment tax credit, thus triggering the corporate minimum tax.

Company B just sits there and does nothing, and incurs no minimum tax liability. It is difficult to nationalize that the enlightened management of company A gets penalized by the corporate minimum tax.

I would urgently and strongly urge the committee as you look at accelerated capital cost recovery, to please take a look at the corporate minimum tax, because it works in direct contradiction to everything you are doing on the other front.

Thank you very much.

The CHAIRMAN. Senator Long.

Senator LONG. Let me just say this about that minimum tax. Obviously, it leaves a lot to be desired. It's not a very good tax and at the very beginning it never should have been an add-on tax. The only reason that it's an add-on tax is because nobody could come up with something better than what we had at the time. But now you used to deal with that fiasco. Rather than just finding fault

with the fiasco we have here, you ought to come up with an idea. You folks can afford to hire an accountant.

Well, hell, they hired you didn't they? They can afford a tax lawyer. [Laughter.]

Mr. SMITH. That's pretty cheap labor, Mr. Chairman.

Senator LONG. Well, I feel like telling you don't bring us any more problems. Bring us some answers. Have you got some answers. That's something we can use, because I personally very strongly feel that we've got to get rid of that minimum thing as an add-on. It ought to be an alternative.

Basically, the question is, if you had in economic terms, the way you tell your banker, if you really made money, you had a good year, you ought to pay us something, and you didn't make anything, well then of course you shouldn't have to pay anthing, but basically the minimum tax laws ought to take into view that you take advantage of all the complexities there are in the code, where you don't owe us anything, well we're going to tax you on a different basis. On that basis you'll still owe us something.

You were around here when that happened——

Mr. SMITH. Yes, I was.

Senator LONG. By now the business community ought to be able to show us a better way to do it. Because you and I know, I think everybody here knows that mechanically at some points, if you can't agree, well, then you'll just have to have a difference of opinion, but when a person makes a lot of money in economic turn he ought to pay us something. And, the public just can't understand that. Here is a little guy making $10,000 a year and he's paying an income tax, little though he can afford it. And, here's some fellow who made $100,000 or $1 million and does not pay anything. And, people get outraged about that.

Frankly, they look at us and say why don't you make those people pay some taxes. Why did you tell it to your grandfather, here a guy got a way with a silver butterfly deal and has been getting away with it for years and paid us nothing. Why don't you people do something about that.

What would you say if you were a candidate for office down there and had to run a home district.

Mr. SMITH. Senator, having been here in 1969 and being familiar with the public outrage at that time, I think I fully understand and share the judgment made in terms of individuals.

I am not certain that those same arguments necessarily apply in the case of a corporation that is experiencing a period of low or no profitability.

It seems to me that when we're trying to encourage capital investment, investment in new plant and equipment; and many of these companies, steel companies, mining companies are in cyclical periods of low profitabilty, when they need more cash flow, it is illogical to hit them with a 15-percent-add-on tax.

Senator LONG. Yes, but if he want's to get rid of that tax, you ought to be willing to bring us something here—the people who really owe us some money would pay some.

Now, look, you know as well as I know a—rather I understand the oil industry pretty well. If we didn't have a minimum tax, it would be very easy for somebody to be successful to work it out. So

he doesn't have to pay us any tax. Every year just take a look and see what he's going to owe us. So, coming down the home stretch, he does an awful lot of drilling, and he just drills up by way of his intangible drilling costs, what he otherwise would owe us. He could deduct—about 70 percent of your cost is your intangibles, and he could have a drilling program to drill up enough to where he doesn't owe us anthing, and that's how some people did business. It's almost a game with them.

And, so we put a minimum tax in there. There was nothing awful about it. My reaction is, well, hell, they ought to pay something. You agree with that, don't you.

Mr. SMITH. I think I share your sentiments in the case of individuals. I'm not certain that I share them in the case of corporations.

It generates as I said, in 1977 $267 million in taxes versus $56 billion from the regular corporate tax.

Senator LONG. But, you're making your case by talking about a situation where the people didn't really make any money, and I'm just saying that you ought to help draft up the situation where they made money.

[Senator Baucus arrives.]

The tax always was supposed to direct itself to the situation where the guy does like my friend in the oil business. He goes down to borrow some money and the guy says, well, how did you make out last year.

My friend says well, now look, let's understand for tax purposes, I broke even. Let me show you what I really made. For example, I drilled all these wells, and some of them were dry holes, but several of them were very good wells.

I've got a frontend writeoff, but next year or the year after, I'm going to have a lot of income from these wells, unless I drill a lot of wells again next year.

I think that we're pretty well across the—in saying that if in economic terms they made money, they ought to pay us something. Are you arguing against that?

Mr. SMITH. I am not arguing against that in the case of individuals.

Senator LONG. In corporations are you?

Mr. SMITH. I think as long as corporations are doing things to reinvest that cash flow an add-on tax is inappropriate. Oftimes the corporate minimum tax is triggered because of the application of the investment tax credit.

In the offsetting computation, the regular corporate tax is compared with the preference item after the reduction for the investment tax credit. If you just grossed up the investment tax credit you would ameliorate part of the problem right there.

Senator LONG. Well, you've got me sold by the way. But, we can both agree that it can be an add-on tax, an—not add-on, but alternative—alternative tax, and the alternative tax on a—situation.

Now, if a guy would like to work it out so he doesn't owe us any taxes, but even though he made a lot of economic income with his corporation. We ought to collect something. You ought to be able to work out something. If you could recommend to us——

Mr. SMITH. Yes sir, we'll try to be creative.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. I'll have to share some of the same concerns as Senator Long. People who really make a substantial economic turn, whether its corporate or individual, have to pay some tax, I think, or you're not going to have any faith in the system.

But, your argument that the corporations should be exempted and perhaps the individual shouldn't, I don't quite follow that, because with the investment tax credit on the alternative minimum, you don't get the utilization of that.

You've got all your so-called preference items that are listed and then individuals, just as a corporation, can be investing to try to rebuild America. It doesn't just have to be just through the corporate structure.

And, yet, we have to come down finally by saying that people have to pay some taxes, and shouldn't be in a situation where they can just write everything off.

Mr. SMITH. But, do you believe, for example, Senator, that corporations ought to have a Federal income tax liability when they have had a net operating loss for——

Senator BENTSEN. No, no.

Mr. SMITH. The corporate minimum tax imposes such a tax.

Senator BENTSEN. The other concern that I get is in the way Senator Long, making reference to people having substantial incomes and not paying a tax.

I think part of the problem also is our Treasury reported incomes. And, whether they really had an aggregate income or net income, the type of income that they were reporting led to a great deal of misunderstanding as to what the true income was.

[Senator Bradley is here.]

Mr. SMITH. We know also, that in the case of individuals, that the preference items in the code are often used skillfully for shelter purposes.

Senator BENTSEN. That's correct.

Mr. SMITH. In the case of the companies that we represent here, the preferences occur in the ordinary course of business.

Senator BENTSEN. You don't think they use them skillfully to reduce taxes?

Mr. SMITH. I think they use them as well as they can but they arise in the normal course of business, iron ore mining, whatever.

Senator BENTSEN. I don't think that they—and I've sat on a number of corporate boards, I just don't believe that they do it with out some understanding of the tax system in trying to reduce their taxes also.

Mr. SMITH. Indeed.

Senator BENTSEN. So, see if you can come up with some creative thinking for us to accomplish the objectives that you want, and that we want.

Mr. SMITH. Thank you.

The CHAIRMAN. Senator Bradley.

Mr. BRADELY. No, Mr. Chairman, I don't have any questions for this panel.

The CHAIRMAN. I have no questions, but I certainly agree with Senator Long. About 2 weeks ago we had to come in here and cut student benefits, medicaid and 30 to 40 different programs to minimum benefits—save some money, and we can figure out a lot of

ways to dish it out and you have one way. I hope we're not going to get into that game for the rest of the balance of the hearing. Everybody come in and want a little special treatment. There won't be anything left for the individual—tax reduction. And, I can't speak for the administration, but I hope with some that we have a clean bill, that you support the clean bill with the exception of your little amendment is that what you're saying. Everybody else supports it with the exception of their little amendment, pretty soon they have got a Christmas tree.

Mr. SMITH. I am certainly sympathetic with that problem. I would suggest in terms of achieving the optimal benefits of the administration's program, that as I say for companies that are impacted by the minimum tax, they will receive 85 percent of the benefit obtained by other companies. This will be true for steel companies, mining companies, and many rail transportation companies, because of the minimum tax.

The CHAIRMAN. I think the same is true of the other proposals. I don't have to make an issue of what you would like us to do, but I do think we are going to have certain limitations on the first and second bills. If, in fact, we follow the administration's direction and pass a clean bill, we will come back with a second bill. In that bill we're going to have limited revenue, and it will be up to the Congress to make the decisions on priorities. I'm not certain that yours will be on that list. On your list, it will probably be on top.

Sir, you probably understand the problem better than most.

Mr. SMITH. Yes, sir.

The CHAIRMAN. Thank you very much.

Mr. CHRISTRUP. Thank you.

Mr. O'CONNELL. Thank you.

Mr. SMITH. Thank you.

[The statements of the preceding panel follow:]

PRINCIPAL POINTS OF
STATEMENT OF
G. KENNETH CHRISTRUP
DIRECTOR OF TAXES, XEROX COPRORATION
ON BEHALF OF
THE ROCHESTER TAX COUNCIL
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON S. 683
MAY 19, 1981

I. The Rochester Tax Council ("the Council") supports S. 683 in its entirety subject to three technical corrections.

A. Section 207 of the bill, which provides rules for the computation of earnings and profits, will have an adverse effect on the amount of foreign tax credits allowed to United States companies without any corresponding reduction in foreign taxes paid which, in some cases, will more than offset the tax incentives for capital investment provided by the bill.

B. The requirements of the bill that gain or loss be recognized upon the disposition of recovery property will also have a serious adverse impact on foreign tax credits. The gain or loss rule is appropriate for a company obtaining the benefit of accelerated cost recovery but should not be imposed in those situations where this benefit is not made available.

C. Tax simplification would be served by placing property used in connection with research and experimentation in the five year recovery category rather than the three year category without any loss in research and experimentation

incentives. The Council also recommends passage of a bill such as H.R. 2473 which would restore the incentives for conducting research in the United States which the Treasury Department eroded in its regulations under Section 861-8.

II. If the Senate Finance Committee does not fully support S. 683, the Council urges that the 10-5-3 lives be left intact for tangible personal property and that the lives for real property be extended rather than incorporating the 2-4-7-10 system. The tax incentives provided under 2-4-7-10 are significantly less than the 10-5-3 proposals for high technology companies.

III. The Council supports the Administration's program for a "clean" bill but notes that the most significant encouragement to businesses in a second tax bill would be a reduction in the top corporate tax rate.

**STATEMENT OF
G. KENNETH CHRISTRUP
DIRECTOR OF TAXES, XEROX CORPORATION
ON BEHALF OF
THE ROCHESTER TAX COUNCIL
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON S. 683
MAY 19, 1981**

Mr. Chairman, my name is G. Kenneth Christrup, and I am Director of Taxes of Xerox Corporation. I am appearing before you today on behalf of the Rochester Tax Council, an organization of companies having strong affiliations with the Rochester, New York, area. The Council members include:

Bausch & Lomb, Inc.
Champion Products
Corning Glass Works
Eastman Kodak Company
The R. T. French Company
Gannett Co., Inc.
Garlock, Inc.
Gleason Works
Schlegel Corporation
Security New York State Corporation
Sybron Corporation
Xerox Corporation

While these member companies are engaged in a variety of businesses, including communications and banking, most of the member companies are engaged in the manufacture and sale of high technology products throughout the world.

Council Generally Supports
Administration's Tax Program (S. 683)

The Council supports S. 683 in its entirety, subject to certain technical corrections discussed below.

Since our direct concern and knowledge relates to Title II, we will limit our comments on S. 683 to that title.

The Council has long been on record as strongly supporting the Capital Cost Recovery Act, the so called 10-5-3 depreciation bill which was introduced in the last Congress by Senator Danforth as S. 1597. While we prefer certain features of this bill, we support Title II of S. 683. Since much of the machinery and equipment of the member companies already qualifies for useful depreciation lives that are equal to, or not significantly greater than, the 10-5-3 lives under S. 683, this support is not based primarily on the direct benefit that most of the members of the Council would receive from this legislation. Rather, we primarily base our support on the conviction that this legislation will accomplish its goals of stimulating substantial capital investment by business, simplifying record keeping requirements and minimizing tax disputes. In view of the extensive testimony you have received on the economic policies supporting this legislation, no additional comments in that area need be added by us.

Technical Reservations Regarding S. 683

We do, however, wish to bring to your attention some important technical problems in S. 683 which need correction. First, and most important to us, is the calculation of earnings and profits for foreign subsidiaries under section 207 of the bill. Section 207 provides a generally

mandatory rule as to the amount of depreciation allowed in each accelerated cost recovery class (*i.e.*, 10-5-3 classes) in computing earnings and profits. The recovery lives are extended as follows:

> 5-year life, straight-line method for 3-year recovery property.
>
> 10-year life, straight-line method for 5-year recovery property.
>
> 20-year life, straight-line method for 10-year recovery property other than section 1250 property.
>
> 33-1/3 year life, straight-line method for 10-year recovery property which is section 1250 or section 167(r) property.

This mandatory rule for determining the amount of the depreciation deduction in calculating earnings and profits applies to foreign, as well as to domestic, corporations. The application to foreign corporations has the consequence, apparently unintended, of reducing the amount of indirect foreign tax credits presently available to United States corporations owning 10% or more of the voting stock of a foreign corporation. The decrease in credit is not attributable to any decrease in foreign taxes paid but results from foreign subsidiaries having their earnings and profits increased by section 207 of the bill since many of them already use Internal Revenue Service approved lives which are substantially shorter than the earnings and profits lives found in the bill. The consequence is that each dividend paid becomes a smaller portion of the foreign

company's earnings and profits which directly causes a reduction in allowable foreign tax credits. Since this reduction in credit is not accompanied by any reduction in foreign taxes paid, section 207 results in an overall tax increase.

In the case of companies that have relatively short life machinery and equipment in their foreign subsidiaries (*e.g.*, computers and copiers), the tax increase can be, and generally would be, enormous. For example, one of the members of the Rochester Tax Council estimates that if S. 683 had been in full force in 1979 -- a relatively typical year for that company -- the tax savings resulting from the ACR System through its operations in the United States would be considerably more than offset by decreased foreign tax credits due to this extension of lives and elimination of rapid depreciation in calculating earnings and profits of such foreign subsidiaries under section 902. Thus, for this company, and for several other major companies in the United States that employ machinery and equipment that has a class life of less than 10 years, the Administration's bill, as now drafted, has a disastrous consequence of substantially increasing the taxes paid by such companies.

We wish to make it clear that this problem is not caused by the Administration's policy decision to limit

the benefits of the accelerated cost recovery system (ACRS) to depreciable property predominantly used within the United States. This understandable policy decision, while denying the benefits of the ACR system to assets located outside the United States, would not deprive taxpayers of using present rules to calculate depreciation on such assets.

Happily, responsible Treasury Department officials have indicated that they also support technical revisions of the bill to remove the inequity found in section 207 of the bill. The goal should be to leave the methods of calculating depreciation of the assets of foreign subsidiaries unchanged. This can be simply and directly accomplished by following the precedent which Congress established in 1972 when it provided in present section 312(k) that corporations generally shall use the straight-line method of depreciation in calculating earnings and profits but expressly provided in section 312(k)(3) that this rule would not apply to the earnings and profits of a foreign corporation in any taxable year for which less than 20% of the gross income from all sources of such corporation were derived from sources within the United States. This would simply leave the present rules intact for foreign subsidiaries so that the legislation would accomplish its apparent intent of providing no benefits, but remaining neutral, with regard to calculation of foreign tax credits. It also has the advantage of permitting United

States corporations to continue to use the methods of depreciation that have been established and accepted regarding foreign subsidiaries.

While the Council would certainly prefer this approach of neutrality by following the principals adopted in section 312(k), we understand that the Administration may favor other approaches which would abolish both the ADR system and the facts and circumstances rules, and substitute ADR class lives with accelerated rates. For the reasons stated, we believe the better approach is to leave the present rules intact for foreign subsidiaries. Nevertheless, we would welcome the opportunity to work with the staff of this Committee, the Joint Committee staff and the Treasury Department in reaching an acceptable resolution of this serious technical flaw.

The second technical problem that concerns us is closely related to the first one. S. 683 would require that gain or loss shall be recognized on the disposition of recovery property unless the nonrecognition is specifically required or permitted by another provision of the Code or the taxpayer elects to include in income all proceeds realized on the disposition from mass assets accounts. Again, our concern is with the impact of this rule on the foreign tax credit calculation under section 902.

Under the present ADR system, gains and losses ordinarily are not recognized but all proceeds are added to the depreciation reserve of the vintage account from which the retirement occurs. The proposed system would generally accelerate the time when gains or losses are recognized from dispositions. While this may well be both reasonable and appropriate in changing from an ADR system to an ACR system for United States property, it seems unfair and distorting to require immediate recognition of gains or losses by a foreign subsidiary that receives no benefits from the ACR system. As in the case of depreciation of foreign assets, the equitable and simple resolution of this technical problem is to continue the present system for determining gain or loss on the disposition of depreciable property held by foreign subsidiaries.

Property Used in Research and Experimentation

The bill includes tangible section 1245 property used in connection with research and experimentation in the 3-year recovery category. The Council understands that this is intended to encourage research activities. The Council believes, however, that this will provide no effective stimulus to research expenditures and recommends leaving research property in the 5-year category to which it would otherwise be assigned. It will then be eligible for the

full 10% investment credit rather than the 6% credit to which 3-year recovery property is entitled. This additional credit has as positive an effect as the corresponding effect of claiming depreciation over the shorter time period. In addition, the change we recommended will simplify the administration of the ACR system because it would eliminate disputes stemming from the need to define property used in research and experimentation.

We believe that research and development could best be stimulated in the United States by early passage of a bill such as H.R. 2473 and hope that a comparable bill will be introduced in the Senate. This bill would allocate United States research and development expenditures to United States source income and thereby would reverse the present regulations under section 861 which discourage investment by American business in research and development within the United States. We urge your support of this concept.

Position of the Council if
Substantive Modifications are Required

If this Committee does not fully support the Administration's depreciation proposal on 10-5-3 and concludes that some substantive modifications are required, we recommend against the so-called "2-4-7-10" cost recovery system that was incorporated in the Senate Finance Committee on amendments to H.R. 5859 in the 96th Congress. The combination of useful lives and investment tax credit under that

bill would provide considerably less incentive than the Administration's proposal to high technology companies which have large amounts of machinery and equipment in short-life classes. If revenue constraints or other considerations require modifications, we believe it is more logical to merge, and perhaps somewhat extend, the classification for real property and not to alter the 5-year class with its full investment credit.

Support by the Council of Additional Legislative Tax Reform for Business

Since the Council supports the Administration's program for having a "clean" first bill which is limited to proposals in S. 683, the Council does not at this time advocate other legislative changes. When consideration is given to the second tax bill, we believe that, following the depreciation reform that would be produced by S. 683, the most useful encouragement to business through the reform of the tax laws would come by a reduction in the top corporate rate.

SUMMARY OF
STATEMENT OF DANIEL K. O'CONNELL
EXECUTIVE VICE PRESIDENT, RYDER SYSTEM, INC.
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
May 19, 1981

Ryder System, Inc.'s basic business is full-service truck leasing and rental. Under existing law, it may depreciate its power equipment over 3 years. Its usual replacement cycle for its power equipment is 3-1/2 to 4 years. Ryder is concerned about the effect of capital cost recovery tax legislation on productive assets with shorter replacement cycles such as trucks, computers, office equipment and farm machinery.

Ryder urges the Committee to adhere to these three principles in considering capital cost recovery tax legislation:

1. The legislation should reduce or eliminate present law discrimination against assets with shorter replacement cycles by allowing an improved investment tax credit for such assets.

2. In the event it is deemed necessary to limit the legislation's incentive effect so that Congress is forced to choose between improvement of the investment tax credit and the rate of depreciation for assets with shorter replacement cycles, Congress should recognize the special and important incentive effect of the investment tax credit and favor it over depreciation liberalization with respect to such assets. Specifically, this result can be accomplished within any targeted limitation directed at assets with shorter replacement cycles by requiring a slower method of depreciation for such asset categories, such as 150% declining balance or straight-line, while allowing a greater investment tax credit. In the event it is deemed necessary to have cost recovery periods with differing rates of investment tax credit, taxpayers should be permitted to elect a longer cost recovery period in order to obtain a greater investment tax credit.

3. Any investment tax credit recapture provisions should be graduated at intervals no greater than one year.

We, at Ryder, support the treatment of the investment tax credit contained in the President's capital cost recovery proposals. In the event it is deemed necessary to modify the President's capital cost recovery program, we urge that the modifications adhere as closely as possible to the principles and proposals set forth above.

In the rush to shorten capital cost recovery periods, we urge that the importance of the investment tax credit as a vital incentive to business not be forgotten. Under no circumstances should any company be required to sacrifice its investment tax credit as the price for obtaining a shorter cost recovery period. It is a trade-off that would serve no purpose. We further urge that any capital recovery program that might be adopted move in the direction of allowing an improved investment tax credit for assets with shorter replacement cycles.

STATEMENT OF

DANIEL K. O'CONNELL

EXECUTIVE VICE PRESIDENT, RYDER SYSTEM, INC.

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

May 19, 1981

Ryder System, Inc.
3600 Northwest 82nd Avenue
Miami, Florida 33166
(305) 593-3800

STATEMENT OF

DANIEL K. O'CONNELL, EXECUTIVE VICE PRESIDENT

RYDER SYSTEM, INC.

Mr. Chairman, Members of the Committee, I thank you for the opportunity to present the views of Ryder System, Inc., on the important topic of capital cost recovery tax legislation.

I am Executive Vice President of Ryder System, Inc. Ryder's basic business is full-service truck leasing and rental. Under a full-service lease the customer is furnished, along with the truck, all necessary service supplies and equipment, including maintenance, parts, tires, licenses, taxes, a substitute vehicle if needed, and usually fuel and insurance. Our customers range in size from individuals to large corporations. Great amounts of capital are required to maintain the large fleet of trucks and supporting operations. Our power equipment can be depreciated over a 3 year period under existing law. Ryder actually replaces its power equipment in 3-1/2 to 4 years in most cases. Accordingly, Ryder is particularly concerned about the effect of cost recovery tax legislation on productive assets with shorter replacement cycles, such as trucks, computers, office equipment and farm machinery.

Principles for Legislation

I am here today to urge that Congress and this Committee adhere to certain principles in considering any capital cost recovery tax legislation. These three principles are:

First, the legislation should reduce or eliminate present law discrimination against assets with shorter replacement cycles by allowing an improved investment tax credit for such assets.

Second, in the event it is deemed necessary to limit the legislation's incentive effect so that Congress is forced to choose between improvement of the investment tax credit and the rate of depreciation for assets with shorter replacement cycles, Congress should recognize the special and important incentive effect of the investment tax credit and favor it over depreciation liberalization with respect to such assets.

Third, any investment tax credit recapture provisions should be graduated at intervals no greater than one year.

Explanation

1. Present law discrimination against assets with shorter replacement cycles should be eliminated or reduced by allowing an improved investment tax credit for such assets. Existing law allows a 10% investment tax credit for certain

depreciable assets with depreciable lives and replacement cycles of at least 7 years. Assets with depreciable lives or replacement cycles of 3 or 4 years are allowed only a one-third credit, and those with depreciable lives or replacement cycles of 5 or 6 years are allowed a two-thirds credit. We believe that the reasons which led the Administration in 1974 to recommend removal of the restrictions on assets with depreciable lives of at least 3 years remain unchanged today. Briefly stated, the principal reasons favoring removal of the present law discrimination against shorter-lived assets are: (1) improved tax equity, (2) improved economic stimulus to business investment and creation of more jobs, and (3) tax simplification. A simple example clearly illustrates the unfair discrimination of the existing system against users of assets with shorter replacement cycles:

Example. X purchases a machine with a useful life and replacement cycle of 9 years for $9,000. Y purchases a machine with a useful life and replacement cycle of 3 years for $3,000. Y must replace the machine each 3 years so that at the end of 9 years Y has also expended $9,000. Even though X and Y have each expended $9,000 over the same period of time, under existing law, X is allowed 3 times the amount of investment tax credit as Y.

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In this regard it is important to note that it is not appropriate to compare, for example, an initial expenditure of $1,000 for a shorter-lived asset with the same dollar expenditure for a longer-lived asset, as some examples in recent years have done. Such comparisons fail to consider that the shorter-lived asset must be replaced more frequently.

2. Congress should recognize the special and important incentive effect of the investment tax credit and, in the case of assets with shorter replacement cycles, favor it over depreciation liberalization in the event it is deemed necessary to choose between the two. For many years the investment tax credit has been the cornerstone of the tax incentive program to encourage modernization and expansion of the nation's plant and equipment. From our experience at Ryder, it has been an effective stimulant. A dollar of investment tax credit has a greater incentive effect than a dollar of tax savings from accelerated depreciation, even if the two are equivalent on the basis of the present value of cash flows. This is due in part to the method required, by generally accepted accounting principles, for the reporting of the financial results of a business firm's operations. The investment tax credit is reported as a reduction in tax liability for financial reporting purposes, thereby increasing

net after-tax earnings. On the other hand, the tax reduction attributable to the excess of tax depreciation over book depreciation must be shown as a "deferred tax liability", and accordingly, is not reflected as an increase in the firm's after-tax net income. Thus, dollar for dollar, a greater incentive effect can be achieved by improvement of the investment tax credit than by changes in depreciation, even though the revenue loss to the government is the same. In constructing an improved capital cost recovery system for assets with shorter replacement cycles, it is important to favor improvement in the investment tax credit over depreciation liberalization if a choice is made between the two.

A structure favoring investment tax credit would also be of particular benefit to small business corporations with tax rates lower than 46%.

Several cost recovery proposals which have been structured as alternatives to the Administration's proposal would provide limitations on the depreciation and investment tax credit incentive so that the present value of the tax benefits from depreciation and the investment tax credit would not exceed the tax benefit that would be available from current expensing. These alternative proposals, as presently structured, impact shorter-lived asset categories by limiting the

amount of investment tax credit rather than limiting the rate of depreciation. If a limitation is deemed necessary, the proposals should be modified to favor the investment tax credit over depreciation liberalization for shorter-lived assets.

Any of the alternative capital cost recovery proposals can be modified to accomplish this result by increasing the amount of investment tax credit for assets placed in the shorter recovery periods, while limiting the method of depreciation for such shorter-lived categories to the 150% declining balance method or straight-line method (rather than the double declining balance method).

For example, if a "2-4-7-10" cost recovery approach were used, the 2-year and 4-year categories would be limited to the use of straight-line depreciation. This would permit the allowance of a full 10% investment tax credit for the 4-year category and a 5% investment tax credit for the 2-year category, while meeting the targeted limitation. The 7-year and 10-year categories would be allowed a full 10% investment tax credit and could compute depreciation based upon the double declining balance. Investment tax credit recapture would be structured as follows:

Asset Held	ITC Retained
Less than 1 year	0
1 year	2-1/2%
2 years	5%
3 years	7-1/2%*
4 years or more	10%*

If a "3-5-7-10" cost recovery approach were used, the 3-year and 5-year categories would be limited to the use of 150% declining balance depreciation. This would permit the allowance of the full 10% investment credit for the 5-year category and a 6% investment credit for the 3-year category, while meeting the targeted limitation. Investment tax credit recapture would be structured as follows:

Asset Held	ITC Retained
Less than 1 year	0
1 year	2%
2 years	4%
3 years	6%
4 years	8%**
5 years	10%**

It is believed that, if limitations are deemed necessary, all businesses would favor the above limitations on depreciation as opposed to limitations on the investment tax credit. Nevertheless, in the event that some business investors in shorter-lived assets would favor accelerated depreciation

* Does not apply to the 2-year category.
** Does not apply to the 3-year category.

over the investment tax credit, an election could be permitted for such a taxpayer to compute its depreciation for shorter-lived asset categories under an accelerated method (such as double-declining balance) with a reduced investment tax credit.

Also, in the event it is deemed necessary to have cost recovery periods with differing rates of investment tax credit, taxpayers should be permitted to elect a longer cost recovery period. Several proposals which have recently surfaced have several cost recovery periods, some of which periods provide for less than a full investment tax credit. The recovery period in which an asset would normally fall would depend upon its depreciable life under existing law. If Congress were to adopt such an approach, we urge that a taxpayer be permitted to elect a longer recovery period for any depreciable asset, in order to obtain a greater investment tax credit. We are happy to note that most of the proposals along this line we have examined to date allow such an election.

3. Any investment tax credit recapture provisions should be graduated at intervals no greater than one year, to minimize distortion of equipment replacement decisions. The investment tax credit recapture provisions in existing

law apply a "steep cliff" approach, resulting from the 2-year recapture intervals. For example, if an asset with a depreciable life of 7 years is actually held 5 years, one-third of the credit is recaptured and must be paid back to the government. One-third of the credit is also recaptured if the same asset were disposed of in 6 years rather than 5 years. Some of the alternative cost recovery proposals use a similar "steep cliff" approach to investment tax credit recapture. The Administration's "10-5-3" cost recovery proposal uses a more graduated approach to investment tax credit recapture. Under the Administration's cost recovery proposal, an asset which is placed in a 5 year cost recovery classification is allowed a full 10% investment tax credit. If an asset is disposed of before 5 years, the taxpayer retains an investment tax credit after recapture equal to 2% for each full year the asset was held.

The "steep cliff" approach to recapture operates contrary to the purpose of the investment tax credit by actually discouraging replacement of assets before they are held the requisite period. The graduated approach to investment tax credit recapture, such as contained in the Administration's proposal, greatly lessens any inclination of a business to retain an asset beyond the time that it would otherwise economically make sense to replace the asset.

Conclusions

We, at Ryder, support the treatment of the investment tax credit contained in the Administration's capital cost recovery proposals. In the event it is deemed necessary to modify the Administration's capital cost recovery program, we urge that the modifications adhere as closely as possible to the principles and proposals set forth above. These principles and proposals are readily adaptable to any capital cost recovery alternative.

As previously recommended, the legislation should also allow a taxpayer to elect a longer cost recovery period for any shorter-lived assets.

In the rush to shorten capital cost recovery periods, we urge that the importance of the investment tax credit as a vital incentive to business not be forgotten. Under no circumstances should any company be required to sacrifice its investment tax credit as the price for obtaining a shorter cost recovery period. It is a trade-off that would serve no purpose. We further urge that any capital recovery program that might be adopted move in the direction of allowing an improved investment tax credit for assets with shorter replacement cycles.

STATEMENT OF JAMES E. SMITH
BEFORE THE
SENATE COMMITTEE ON FINANCE
WASHINGTON, D.C.
MAY 19, 1981

Mr. Chairman and Members of the Committee, my name is James E. Smith. I am President of Charls E. Walker Associates, Inc. I am appearing today representing a group of twenty companies to urge repeal of the minimum tax as it applies to corporations. These companies include a railroad, steel companies, and certain coal and hard mineral mining companies. A list of the companies is attached to my statement.

Our group of companies is strongly in favor of the President's Tax Program, and we urge that his recommendations be promptly accepted by the Congress. Economic revitalization is a matter of some urgency for this nation, and we believe that prompt enactment of the proposed Economic Recovery Tax Act of 1981 without significant change is in the public interest. Repeal of the corporate minimum tax is thoroughly consistent with the goals of the President's proposal. In the case of companies and industries with low profitability, it has the effects of impeding capital formation and cash flow. Indeed, if the corporate minimum tax is not repealed, companies impacted by it will not obtain the maximum cash flow benefits intended from a liberalized cost depreciation system. Relief from its adverse effects should be seriously considered by this Committee.

The companies in our group are capital-intensive companies which, for the most part, are suffering from low profitability. In order to be revitalized, they must make large capital expenditures over the next few years. Their ability to do so is frustrated by the minimum tax.

The minimum tax for corporations was added during consideration of the minimum tax for individuals. The legislative history does not make at all clear the reasons for a minimum tax on corporations. It was originally passed by the Senate and approved in Conference, as a provision in the Tax Reform Act of 1969.

The minimum tax on corporations raises relatively small amounts of revenue -- $267 million in the last year for which statistics are available -- 1977. The estimate for 1981 is $370 million. However, the tax falls heavily on a few industries -- primarily mining and steel manufacturing. As you know, the minimum tax on corporations is imposed at the rate of 15 percent on the excess of preference items over regular income tax paid. Thus, as regular income tax is significantly reduced, the preference items, which arise in the normal course of business, while perhaps not large in relation to the size of the corporation, may nevertheless exceed the regular tax and trigger a 15 percent minimum tax thereon. Incidentally, this may occur even though the company may have a regular tax liability in the tens of millions of dollars. The minimum tax paid by the corporations in the group for which I am speaking does not grow out of the use of tax shelters to offset unrelated income. Most of these companies pay minimum tax because their profits, and, therefore, their regular tax liability, are relatively low in relation to their preference items which arise in the conduct of their business.

Lowered profits, and hence lowered regular tax, results from many factors adversely affecting the companies in the group. Inflation, of course, impacts all of us. Some of the companies are in cyclical downturns. Some of the companies are suffering from competition from lower-priced imports. Many of the companies have been forced to make large expenditures

for pollution control equipment. The mining companies, particularly, are faced with heavy costs growing out of increased awareness of the necessity to protect the environment, and the fact that the minerals they extract become increasingly less accessible. At the same time, they are beset with lower world prices for many of the commodities they produce.

It is in the interest of the nation to enable our basic industries to modernize so that they can better compete with imported goods. It is also in our nation's self-interest to avoid becoming increasingly dependent upon raw materials imported from abroad.

In 1980, the Panel on Defense Industrial Base of the House Committee on Armed Services reported that since 1950, "our raw materials situation has deteriorated drastically." It reported that the United States is more than 50 percent dependent on foreign sources for over half of the approximately 40 minerals most essential to our economy, and that the dependence on foreign sources for vital raw materials has been increasing for many years. This dependence has economic importance, but also strategic importance to our nation's defense program. It is folly to exacerbate this situation through unwise taxation.

Last year also, the Subcommittee on Mines and Mining of the House Committee on Interior and Insular Affairs reported that Federal tax laws "have not kept pace with the changed circumstances confronting the mining industry. They have not accorded any meaningful recognition of the capital and operating cost burdens currently placed on that industry. Greater incentive must be provided to assist the industry, not only in meeting its general capital needs for the development and expansion of productive capacity, but also in alleviating the burden imposed on the industry by mandated environmental and health and safety expenditures."

The minimum tax as applied to corporations runs counter to this sage advice. Adversely, as the profitability of the minerals industry has decreased, the minimum tax has increased. This is true also for the other companies in this group. Thus, not only is the minimum tax a regressive form of tax, but, at least for the companies in this group, it is triggered not by high profits sheltered from taxation, but rather by lowered profits. In some cases, it is triggered for previous years by loss carrybacks, and for subsequent years by loss carryforwards.

I should like to emphasize that the tax preference items which create the minimum tax in the case of the companies in this group do not result from activities entered into for the purpose of sheltering unrelated income from taxation, but occur in the normal course of trade or business of the taxpayer. These corporate preference items were carefully considered inducements to basic industries, and are thus performing the functions for which they were enacted rather than, as may sometimes be the case with individuals, being used merely to shelter income from other activities.

An unfortunate and perhaps unforeseen effect of the minimum tax is that it reduces the benefit to these particular taxpayers of existing capital cost recovery and incentive items. For example, the minimum tax on a corporation can effectively reduce the investment tax credit from a value of 10 percent of the investment to 8½ percent. It can reduce the effect of rapid amortization of pollution control equipment to the point that corporations are sometimes better off not using this tax incentive. Similarly, it will, for certain companies, dilute the incentive for productive investment which is

sought from the accelerated cost recovery system under consideration by this Committee. A more complete listing of some of the other anomalies that result from the imposition of a minimum tax on corporations is included in the longer paper attached to my statement, as Appendix A.

Also attached is Appendix B, which presents several working examples illustrating the contradictory effect of the minimum tax on other provisions of our tax law. Our group believes strongly that the minimum tax is not in the national interest. We are convinced, as we trust you will be, that the minimum tax on corporations impacts adversely on capital formation and cash flow in ways that were never intended by the Congress. It does not raise large amounts of revenue; it is paid, by and large, by companies of low rather than high profitability; it hampers our national self-sufficiency, especially related to energy and national defense, and ability to compete; and it should be repealed. We urge your careful attention to the inconsistency of this regressive tax with the goals of the President's program.

Minimum Tax Group
Participating Companies

AMAX, Inc.

Armco, Inc.

Bethlehem Steel Corporation

CSX Corporation

Cannelton Industries, Inc.

Carbon Industries, Inc.

The Cleveland-Cliffs Iron Company

Freeport Minerals Company

The Hanna Mining Company

Kennecott Copper Company

LTV Corporation

Lone Star Industries, Inc.

National Steel Corporation

Newmont Mining Corporation

Peabody Coal Company

Pittston Coal Company

St. Joe Minerals Corporation

Texasgulf, Inc.

U.S. Steel Corporation

Wheeling-Pittsburgh Steel Corporation

APPENDIX A

THE CORPORATE MINIMUM TAX:
AN UNRECOGNIZED BARRIER TO CAPITAL INVESTMENT

March 19, 1981

The minimum tax on corporations in practice has a narrow and clearly discriminatory impact on selected industries. It is a drain on badly needed cash flow, and hence a deterrent to savings and investment, particularly in capital intensive industries suffering from low profitability. The tax hits hardest at industries such as steel and mining, where there is a demonstrated and recognized need for increased investment to modernize and improve productivity.

As Congress considers various approaches to increasing the rate of capital formation to spur additional investments, it should recognize that the corporate minimum tax is inconsistent with national policy objectives and should be repealed.

Background

The concept of a minimum tax was first proposed more than a decade ago in response to public concern about a few individuals with large economic incomes who paid little or no income tax. Widespread publicity had been given to the fact that 154 individuals with adjusted gross incomes of more than $200,000 had paid no income tax in 1966. There was a strong feeling that something should be done to curb perceived abuses in tax shelter activities such as limited partnerships in oil and gas, real estate, equipment leasing, etc. In 1969, the first provision to deal with this problem was approved by the House Ways and Means Committee as part of what later became the Tax Reform Act of 1969. The two major features of this provision were that (1) the tax applied only to individuals, and (2) the tax was

comparative, i.e., an alternative tax, rather than an add-on tax.

When the minimum tax concept came before the Senate, it was thoroughly revised and became the basis for the law as it exists today. Perhaps the most significant change was the extension of the concept to corporations. This change came as a result of an amendment added in the Senate and accepted in conference without the benefit of hearings or the presentation of statistical evidence to support such a major change in approach. The Senate Committee Report merely noted that corporations with long-term capital gains, accelerated depreciation, intangible drilling and development expenses and percentage depletion, and financial institutions with special deductions for additions to bad debt reserves, tend to pay smaller amounts of tax than other corporations.

In addition, the concept of the tax was changed to an add-on or supplemental tax rather than an alternative tax; and a flat rate of 10% was established rather than a graduated rate. As finally enacted, the minimum tax also contained a provision which allowed the amount of regular taxes paid in excess of the total tax preferences to be carried forward to as many as seven subsequent years to be added to regular taxes in those years.

The Tax Reform Act of 1976 increased the rate of tax from 10% to 15%. The total regular tax offset allowable to corporations was retained since corporation income is already taxed twice before it is available to the shareholder owners. Also the provision which had allowed the amount by which taxes paid in any year exceeded the sum of the tax preferences to be carried forward for seven years was repealed. This provision which

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permitted the averaging out of the impact of the minimum tax was terminated for no logical reason.

In the Revenue Act of 1978, the Senate Finance Committee had reached the conclusion that the add-on minimum tax "does not serve well either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of tax incentives." In order to eliminate this inequity the Senate version would have changed the concept of the minimum tax as it applies to individuals to a purely comparative or alternative tax. This was done to a limited extent by the alternative minimum tax, primarily applicable to individual capital gains. No changes were enacted for the corporate minimum tax.

How does the minimum tax work in practice?

As presently constructed, the minimum tax on corporations is imposed at the rate of 15 percent on the excess of preference items over regular income tax paid. The major preference items which affect corporations are percentage depletion and net capital gain. Therefore, a reduction in the regular tax liability due to economic reasons or the application of credits can create an additional minimum tax without any adjustment to tax preference items.

For companies that are capital intensive and marginally profitable, the minimum tax has a perverse impact. In many cases the operation of the minimum tax is a direct contradiction of the intent of Congress when it passed many other specific provisions of the tax laws.

Consider the examples below which are applicable to companies

that find themselves subjected to the minimum tax.

* If a corporation had a capital gain on the sale of assets, the tax on the capital gains could be 33.4% because of the minimum tax, in spite of the fact that Congress specifically lowered the capital gains tax from 30 to 28% in 1978.

* Although Congress enacted legislation to allow corporations to amortize the cost of pollution control equipment on a faster schedule, some corporations do not use the incentive because an associated increase in the minimum tax could make the amortization provision less desirable than regular depreciation.

* Some capital investment projects, which could marginally meet the company's return on investment criteria with the investment tax credit considered, may have to be rejected when the minimum tax is computed because the project may no longer meet the company's minimum standards for return on investment.

* The application of energy tax credits in addition to the normal investment tax credit, which Congress passed to encourage conversion and conservation, can increase the minimum tax to be paid, thus partially offsetting the intended benefit. The benefits of the energy tax credit and the regular investment tax credit are effectively reduced from 10% to 8 1/2% by the imposition of a minimum tax even though the rate of credit was specifically provided by Congress.

* A net operating loss created purely by economic events can result in a minimum tax in the current year. A carryback of that loss could create a minimum tax in a prior year where none existed previously, even though tax preference items did not change.

* The minimum tax acts as a direct offset to the carefully considered tax benefit arising from the percentage depletion deduction despite the fact that the percentage depletion deduction is already subject to two limitations, a rate limitation and an income limitation.

* The various accelerated capital cost recovery provisions under consideration will reduce tax liabilities as intended by Congress to aid in capital formation, but in selected cases will at the same time result in a minimum tax liability.

* The application of investment tax credits/energy tax credits reduces the tax liability as intended by Congress while at the same time creating a minimum tax liability.

* Excess investment tax credits which cannot be used to reduce tax liability in the current year can be carried forward and used in future years. However, this could create a minimum tax liability. The same would be true if they were carried back.

* New mining projects normally take five to ten years to reach full development. Cash flows are often the single most important factor in determining whether or not to pursue projects which take this long to develop. The minimum taxes that arise during these low profitability periods have negative impact on cash flows and thereby discourage the development and construction of new mining projects.

* Older mining operations typically work in less desirable minerals and minerals of low seam height. The resulting low profitability generates minimum taxes, without any abusive use of tax preferences. These minimum taxes can be a deciding factor in closing down a mine and abandoning natural resources that otherwise would have been recovered.

Based on the above, it is evident that the minimum tax, which was originally intended to curb tax shelter type abuses by a few high income individuals, can have a major impact on companies with low profits due to economic conditions. Moreover, the companies bearing the main burden of the corporate minimum tax are in basic capital intensive industries -- mining and primary metals -- which are in the greatest need of capital for modernization and pollution control facilities.

Is the minimum tax consistent with other national goals?

As noted earlier in this paper, the minimum tax has had a perverse impact on the mining industry. This situation was addressed by the Subcommittee on Mines and Mining of the Committee on Interior and Insular Affairs in its "Report on U.S. Minerals Vulnerability: National Policy Implications".

This report, published in November, 1980, specifically discusses the tax aspects of the mining industry problems.

"Traditionally, Federal income tax laws have recognized the unique circumstances of the mining industry -- including its fundamental importance to the economy as well as the high degree of risk associated with its investments -- through the percentage depletion allowance and the current expensing of exploration and development costs. These have provided an important source of capital funds for the mining industry, especially for the smaller mining companies which have a narrow capital base from which to finance operations and therefore an even greater need for improved cash flows. Investment tax credit also has been an important incentive for capital investment in the mining industry. ....

Federal tax laws...have not kept pace with the changed circumstances confronting the mining industry. They have not accorded any meaningful recognition of the capital and operating cost burdens currently placed on that industry. Greater incentive must be provided to assist the industry not only in meeting its general capital needs for the development and expansion of productive capacity, but also in alleviating the burden imposed on the industry by mandated environmental and health and safety expenditures. Improved financial posture of the mining industry is necessary if that industry is to regain any semblance of a competitive position in world markets."

Continuation of the minimum tax, which depletes capital, is inconsistent with this policy recommendation.

The minimum tax appears to be at odds with other national policy objectives. For example, the United States is encouraging the development of domestic energy supplies so we will not be dependent on foreign sources. Reliance on imported oil not only raises questions of national security, it also adds to our balance of payments deficits. Yet, mining, including that of coal which is our most abundant domestic energy source, bears a disproportionate share of the minimum tax.

In the area of national defense, the Committee on Armed Services held extensive hearings in 1980 and issued a report entitled, "The Ailing Defense Industrial Base: Unready for Crisis."

One section of the report describes the extent of our dependence on foreign sources for the supply of critical raw materials. The report states:

"There was a time when we produced more raw materials than we consumed. Since 1950, however, our raw materials situation has deteriorated drastically. We have now become dangerously vulnerable to the OPEC-type mineral cartels. The dangers of a high dependence on foreign sources for any item essential to our nation's survival can be best illustrated by the OPEC oil cartel which caused: price escalation, shortages, inflation, dollar devaluation, trade deficits, and economic stagnation. While oil is the best known and the most important single commodity subject to possible cartel-type action, it is not the only one.

The United States is more than 50 percent dependent on foreign sources for over half of the approximately 40 minerals which have been described as most essential to our $2.3 trillion economy.

Last year, the United States had to import over $25 billion worth of non-fuel minerals. This dependence on foreign sources for raw materials vital to our industries has been increasing for many years for several reaons including: technology advancements and legislative and regulatory restrictions imposed on the U.S. mining industry.

Our strategic vulnerability is obvious."

In another section of the report, which discusses industrial preparedness, the panel finds, "...that the Department of Defense has neither an on-going program nor an adequate plan to address the defense industrial base preparedness issue. Department of Defense inaction in enhancing industrial base preparedness, coupled with instability within the five-year defense program, weapons system procurement stretchouts, inadequate budgeting and inflation, has contributed to the deterioration of the U.S. Defense industrial base, and as a result jeopardizes national security".

As the United States attempts to rebuild its defense establishment, which is indicated by the Federal budget submitted by President Reagan, the industrial base is neither capable of supplying the increased demand in a timely fashion nor using the latest technology in the production process. The minimum tax places a burden on the mining industry and basic metals industries and therefore is running counter to national policy objectives.

<u>What impact would repeal of the minimum tax have on revenues?</u>

As the following tables indicate, repeal of the minimum tax would not result in a large revenue loss to the U.S. Treasury. For example, payments for fiscal year 1981 total $250 million. Table A-2 below shows the various specific preference items, and Table A-3 shows the revenues from the corporate minimum tax revenues according to specific preferences. These estimates were prepared by Dr. Gerald Brannon, former Chief Revenue Estimator of the Treasury Department.

TABLE A-1

Repeal of the Corporate Minimum Tax (Sec. 56 IRC) would reduce corporate tax liabilities (or payments) as follows:

	Liabilities (calendar year)	Payments (fiscal year)
	($ millions)	
1981	370	250
1982	395	385
1983	430	415
1984	475	460
1985	525	510

These estimates assume that repeal is effective January 1, 1981. Obvious adjustments would be made for later effective dates which would be in effect rate reductions for 1981 (i.e., effective July 1 means a tax rate of 7.5%).

TABLE A-2

The following table shows the distribution of the corporate minimum tax according to specific preference items based on 1976 data.

($ millions)

Industry	Percentage Depletion	Bank Bad Debt	Acceler. Deprec.	Amortization	Capital Gains Timber	Capital Gains Other	Total
Mining	53.5						53.5
Manufacturing							
Primary Metals	31.7						31.7
Petroleum	9.3						9.3
Lumber & Wood					6.2		6.2
Paper Products					6.0		6.0
Elec./Electron.			1.0			4.2	5.2
All Other	4.8				1.8	7.8	14.4
Gas & Elec. Util.	3.9			3.8			7.7
Trans. Util.	.3			.4		.3	1.0
Finance - Banks		43.1					43.1
Finance - Other	2.0		2.6			3.2	7.8
All Other	3.4	—	2.2	—	—	1.4	7.0
TOTAL	108.9	43.1	5.8	4.2	14.0	16.9	192.9

TABLE A-3

Revenues from the corporate minimum tax according to specific items are as follows:

($ millions)

	1976	1977	1978	1979	1980	1981	1982
Percentage Depletion	109	156	161	145	183	209	207
Bank Bad Debt	43	47	93	103	62	44	62
Accelerated Depreciation	6	9	8	8	8	9	9
Amortization	4	8	8	8	8	8	8
Capital Gains-Timber	14	19	21	40	43	48	55
Capital Gains/Other	17	28	29	35	39	51	55
TOTAL	193	267	320	339	343	369	396

Conclusions

During the 1970's, the American economy was buffeted with strong inflationary pressures and a slow rate of growth. The rate of increase in productivity slowed and actually became a negative rate in the last three years of the decade.

Economists of many differing persuasions have concluded that the best way to increase productivity and reduce inflationary pressures is to encourage badly needed capital investment in new and modern plant and equipment. The Accelerated Cost Recovery System and similar proposals currently under consideration are designed to increase cash flow to allow corporations to replace outworn or outmoded systems and machinery.

The minimum tax would have the contradictory impact of cancelling out some of the benefits of such legislation for many companies in basic industries where relief is most needed.

It would be ironic indeed to see the incentives for business which are contemplated in the new provisions thwarted by the minimum tax which was designed to curb tax abuses by wealthy individuals.

This paper represents the views of the following 20 companies: AMAX, Inc.; Armco, Inc.; Bethlehem Steel Corporation; CSX Corporation; Cannelton Industries, Inc.; Carbon Industries, Inc.; The Cleveland-Cliffs Iron Company; Freeport Minerals Company; The Hanna Mining Company; Kennecott Copper Company; LTV Corporation; Lone Star Industries, Inc.; National Steel Corporation; Newmont Mining Corporation; Peabody Coal Company; Pittston Coal Company St. Joe Minerals Corporation; Texasgulf, Inc.; U.S. Steel Corporation; Wheeling-Pittsburgh Steel Corporation.

APPENDIX B

ILLUSTRATIVE EXAMPLES OF THE MINIMUM TAX IN OPERATION WITH OTHER PROVISIONS OF THE INTERNAL REVENUE CODE

Minimum Tax

Calculation of the Minimum Tax

Basic Example

Tax preference total	$12,000
Less: Tax liability (net)	(2,000)
Excess tax preference over tax	$10,000
Minimum tax @ 15%	$ 1,500

Net operating loss example

	Year 1	
	Before NOL Carryback	After NOL Carryback
Tax preference total	$10,000	$10,000
Taxable income	50,000	-0-
Tax liability	23,000	-0-
Minimum tax	-0-	1,500

	Year 2	
	Before NOL Carryback	After NOL Carryback
Tax preference total	$10,000	$10,000
Net operating loss (carried back to year 1)	(50,000)	
Tax liability	-0-	-0-
Minimum tax @ 15%	$ 1,500	$ 1,500

Excess tax carryover example (repealed in 1976)

		Year 1
Tax preference total		$15,000
Tax liability		25,000
Excess tax carried to Year 2		$10,000
		Year 2
Tax preference		$15,000
Tax liability	$ 5,000	
Excess tax carryforward	10,000	15,000
Excess tax preference—with carryforward (no minimum tax)		-0-
—without carryforward		$10,000
Minimum tax @ 15%		1,500

Example comparing the effect of a deduction for percentage depletion with a deduction for non-preference item

	Preference	Non-Preference
Separate taxable income before deduction	$10,000	$10,000
Separate deduction for:		
Percentage depletion	(6,000)	
Research & development		(6,000)
Net taxable income	$ 4,000	$ 4,000
Regular tax @ 46%	1,840	1,840
Minimum tax:		
$6,000		
(1,840)		
$4,160 x 15% =	624	-0-
Total tax	$ 2,464	$ 1,840

Example showing effect of credits to create a minimum tax

Taxable income before percentage depletion	$25,000
Percentage depletion	(5,000)
Net taxable income	$20,000
Tax @ 46% before application of credits	$ 9,200
(NO MINIMUM TAX AT THIS POINT - TAX LIABILITY IS HIGHER THAN PREFERENCE)	
Credits allowed under Revenue Code:	
Foreign tax	(2,200)
Balance..................................	$ 7,000
Investment tax credit (80% of tax in 1981)	(5,600)
Balance..................................	$ 1,400
Energy tax credit (up to 100% of the tax)	(1,400)
Net tax liability.......................	-0-

Minimum tax:

Preference item	$5,000				
Less net tax	-0-				
	$5,000	x	15%	=	$ 750

Example to show that ACRS (or 10/5/3) will not have full intended effect if the minimum tax is applicable

	Old Depreciation Law	ACRS No Tax Preference	ACRS With Tax Preference
Taxable income before percentage depletion and ACRS or depreciation	$21,000	$21,000	$21,000
Percentage depletion deduction			(5,000)
Any non-preference deduction	(5,000)	(5,000)	
Capital recovery - $50,000 item - 5 yrs ACRS		(10,000)	(10,000)
10 yrs depreciation	(5,000)		
Net taxable income	$11,000	$ 6,000	$ 6,000
Tax @ 46%	5,060	2,760	2,760
Minimum tax:			
Preference item $5,000			
Less net tax 2,760			
$2,240 x 15%			336
Total tax	$ 5,060	$ 2,760	$ 3,096

ACRS should have reduced the tax by $2,300 ($5,000 additional capital recovery x 46% = $2,300)

Because of minimum tax, tax was only reduced $1,964 ($5,060 —3096 = 1,964)

Example to show the possible effect of amortization of pollution control facility compared to depreciation

	Amortize	Depreciate
Taxable income before amortization or depreciation	$50,000	$50,000
$250,000 pollution control facility		
Amortized	(50,000)	
Depreciated		20,000
Net taxable income........................	-0-	$30,000
Regular tax @ 46%	-0-	$13,800

Minimum tax:

Preference item:

Excess of amortization over depreciation	$30,000	
Regular tax	-0-	
Excess	$30,000 x 15% =	$ 4,500

(This will be academic if ACRS or 10/5/3 is adopted since 5 year cost recovery is better than 5 year straight line amortization.)

Example to show that the minimum tax can change the 10% investment tax credit to an 8½% credit

Taxable income before percentage depletion	$14,600
Percentage depletion	(4,600)
Net taxable income......................	$10,000
Tax @ 46%	$ 4,600
(No minimum tax-preference and tax are equal)	
Investment tax credit applied	(1,000)
Net tax................................	$ 3,600

Minimum tax:

Preference item	$4,600				
Less net tax	3,600				
	$1,000	x	15%	=	150

Total tax.............................. $ 3,750

Total net reduction
from $1,000 ITC = $850

The CHAIRMAN. Our next panel is Dr. James Peabody, Mr. Osborn, and Hays Watkins.

STATEMENT OF DR. GEORGE JAMES, ON BEHALF OF AIR TRANSPORT ASSOCIATION OF AMERICA

Dr. JAMES. Thank you, Mr. Chairman. I have noticed from the witnesses who have appeared before you today, that they have one thing in common. That is that they are stressing the need for more investment in the economy.

We have in the airline industry a significant amount of investment as our history will show, and it may surprise some to learn that last year, we invested $4 billion for new equipment, which was more than the steel industry, the textile industry, the aluminum industry or the rubber industry.

The figure will nearly double to some $8 or $9 billion a year by the end of this decade and probably more so by the middle of the decade. We expect to spend $90 billion for new equipment over the coming 10 years.

We have observed that the Department of Transportation has put forth a figure that says for every $1 billion that we invest, we create the equivalent of 60,000 jobs.

We believe, therefore, that we are a significant part of the program that you're anticipating, and hoping to put together for tax reform legislation.

However, we have a very difficult problem in trying to raise sufficient funds to make $90 billion of investment.

In the 1970's we had a profit margin that was only about one-half of the level of the rest of U.S. industry. Last year in 1980, we suffered a $230 million operating loss for the industry as a whole.

We have an investment challenge in front of us, and we consider that the ACRS is indeed a route that we support, and we're encouraged to see it developing. However, we feel that it leaves some significant problems for us, even after its passed, because we will still have in front of us a large investment challenge and behind us a very difficult and unsuccessful profit performance.

Consequently, the investment tax credit which is directed toward those companies that make money should, we believe, also, be directed toward those companies who are not making money, but at the same time contributing equally to the investment posture of the United States.

A dollar invested by a successful company and a dollar invested by a company losing money receives an entirely different treatment by the investment tax credit.

Therefore, we are supporting refundability of the investment tax credit in your legislation. We think that it would be an opportunity not only to help the U.S. domestic economy from the standpoint of this $90 billion that we see in front of us for the next 10 years, but obviously an improvement in U.S. aerospace production and the consequent positive effects it would have on our balance of payments. Moreover, it would improve the productivity of the airlines through the new aircraft that would be delivered and some 30 to 35 percent increase in fuel efficiency that would follow. The airline industry feels an investment of this magnitude is essential to maintain an efficient and reliable national air transportation system.

We think that it is consistent with several national policy objectives including energy efficiency improvements, greater productivity, job creation, and environment progress.

However, the required investment that we will need to make will not be possible in the absence of significant improvements in the economy and significant improvements in our own earnings, and the investment incentives opportunities. As I said, earlier, we support the ACRS; we think it represents a substantial step in the right direction. However, we believe a more complete, effective and equitable capital recovery system should incorporate the investment tax credit improvements, including a provision providing for a refund of the earned but unused tax credits as well.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Peabody.

STATEMENT OF ROBERT B. PEABODY, PRESIDENT, AMERICAN IRON & STEEL INSTITUTE

Mr. PEABODY. Thank you, Mr. Chairman. My name is Robert B. Peabody. I am president of the American Iron & Steel Institute. This statement is submitted on behalf of AISI and its 66 domestic member companies which together supply about 92 percent of the iron and steel which is produced in the United States. These companies employ more than 568,000 workers and have over 800,000 shareholders.

The domestic steel industry believes that the passage of the President's program for economic recovery is essential in order to restore confidence in the economy and achieve the goal of reindustrializing America. We appear here today in support of that program and more specifically to support and urge prompt action by this committee of the 10-5-3 capital recovery proposal, which is the core of the administration's ACRS system.

The United States needs a strong, healthy domestic steel industry. Our world as we know it today could not exist without steel, and that therefore dictates a strong, healthy domestic steel industry.

The domestic industry has problems, they are all now well known. But the industry has the ability to overcome these problems if the Government policies which have substantially contributed to our present difficulties are changed.

Early in 1980, over a year ago, AISI published "Steel at the Crossroads—The American Steel Industry in the 1980s."

In that report we spoke to the need for increased modernization of the domestic industry and pointed out that the basic problem of the industry has been low profitability, a condition which in large measure is the result of Government policies relating to capital formation and capital recovery, international trade, and regulatory burdens, including environmental policies. A number of other studies released in the past year, including reports by the GAO and the Office of Technology Assessment, have agreed that a principal problem of the domestic steel industry is capital formation and that resolution of that problem is dependent upon changes in Government policies in tax, trade, and environmental areas.

Similarly, in September 1980 the Steel Tripartite Committee, made up of representatives of the Government, the steelworkers union, and the steel industry, issued its report.

That report also concluded that the industry is faced with a severe capital shortage, and that changes in Government policies would be required to improve the ability of the industry to further modernize itself.

In brief, the need for changes in our capital formation, capital recovery system in order to facilitate the further modernization of the domestic steel industry, is supported by all who have studied the condition of the industry.

Until 2 years ago, the present ADR system provided a depreciation period of 18 years for steel plant equipment with an allowable reduction of 20 percent.

After major efforts within the Treasury, that was reduced to 15 years with the same percentage reduction. Except for cement, no other major industry in this country has as long a recovery period, and in no other major steel-producing country is there such a long schedule.

Canada, for example, which has a strong, profitable, and modern steel industry permits the recovery of steel equipment capital cost in 2½ years, one reason why across Lake Erie a new greenfield steel plant has been constructed by a Canadian steel company, and none has been built in this country for over 15 years.

The ACRS, or 10-5-3, will not in the short term be of substantial benefit to the domestic steel industry. Because of several years of depressed earnings, the industry has accumulated carryovers of operating losses and investment tax credits which, until they are used in future years, will result in a deferment of the full benefits of 10-5-3.

The industry is firmly convinced, however, that the total economy, including the steel industry, will be best served by the adoption of ACRS as quickly as possible.

The steel industry will benefit in the short term by the prompt adoption of ACRS since its adoption will stimulate increased purchases of steel for capital goods by our customers with the consequent benefit, including increased productivity, which new plant and equipment will bring to our general economy.

In the longer term ACRS will provide major support for steel industry modernization. With inflation, even moderate inflation, ACRS does not permit full recovery in constant dollars.

Nevertheless, the impact of inflation on real capital recovery is much less under ACRS than the present system because the recovery period is shorter.

After the initial phase-in period, the cumulative benefit of capital recovery from the ACRS compared to the existing ADR system would be substantial.

For example, assuming a constant annual level of investment, the cumulative capital recovery after 5 years under ACRS will be almost double that of the present system.

For an industry which has been spending well over $3 billion a year on capital investments and which still has, as stated by the Steel Tripartite Committee, a capital shortfall of $2 billion or so,

this change can be a very substantial benefit to the efforts of the industry to accelerate its modernization.

To conclude, we strongly support the President's program for economic recovery. We believe that program will help restore a highly productive, competitive, and noninflationary economy, all to the benefit of our country and therefore to the benefit of the domestic steel industry, its employees, and shareholders.

A key element of the President's program is ACRS. Accordingly, we urge prompt action by this committee to adopt the ACRS or 10-5-3 approach with an effective date of January 1, 1981.

The CHAIRMAN. Mr. Snow.

STATEMENT OF JOHN W. SNOW, SENIOR VICE PRESIDENT—CORPORATE SERVICES, CSX CORP.

Mr. SNOW. Thank you, Mr. Chairman. My name is John Snow. I am senior vice president of the CSX Corp. By way of background, CSX is a new company in the railroad business, formed last November from the merger of Seaboard Coast Line Industries and the Chessie System, the Chessie System being the C. & O. and the B. & O. and the Western Maryland, and the Seaboard Coast Line being Seaboard Coast Line Railroad and the O. & N.

We have the largest rail hoeing system in the country in terms of revenues and employees. We are also the largest pole-hauling rail system in the country.

And, as with other major rail systems, we undertake heavy capital expenditures; approximately $1 billion are planned for 1981 and over the period 1981 through 1985 something on the order of $1.2 billion annually, therefore generating something on the order of $120 million annually in investment tax credits over that period.

And, as rail systems go, we're relatively profitable, and have been so for a long time. Our 1980 earnings were $280 million. But despite these sizeable earnings, we are unable to fully utilize the investment tax credit, because our taxable income is low, relative to our capital expenditures.

This is a situation which, as you know, is common to other rails and other capital intensive industries, such as steel and the airlines.

Our investment tax carryforward is now in the order of $200 million.

The investment tax credit, in our view, is a mighty effective tax mechanism for stimulating capital formation, but it has one flaw. Senator Long indicated this morning, the companies that need it most, can't fully utilize it, and excuse therefore the competitive balance as a consequence.

I am here today to lend our voice and the many others I think you'll be hearing from in support of the change in the law as proposed in Senator Durenberger's bill to allow capital intensive industries like ourselves to fully utilize on a current basis the investment tax credit.

Now, obviously, what I'm saying and the proposal which I'm endorsing is one which is in our own self-interest. But, I think our own self-interest here parallels a larger national interest.

For one, the change in the law, that I'm supporting would remove the current competitive inequity in the use of investment

tax credit. The situation that was referred to this morning where it cost Chrysler 100 cents on $1 to make a capital investment whereas it cost General Motors only 90 cents on $1. And that's a curious kind of situation.

Second, the proposal as in Senator Durenberger's bill would stimulate capital formation where it is needed most. In the industrial corp of the U.S. economy. The second most in need of assistance and the sector on which revitalization is most depended.

If we are going to revitalize the American economy, we are going to revitalize it through expenditures in airlines, rails, steel, machinery, iron, and so on.

I should close by pointing out that while we support the 10-5-3 and the President's program for accelerated depreciation, we as a company with extensive capital investment tax credit carryforwards won't get much benefit from it.

In fact, it will actually, by lowering our taxable income, exacerbate the problem of the piling up of the investment tax credits. So for all of these reasons we want to lend our voice in support of Senator Durenberger's proposal and suggest that it's an excellent vehicle for accomplishing the objective. But that it's not the only way.

One alternative way to accomplish the same objective would be to make the investment tax credits transferable or negotiable.

Thank you.

The CHAIRMAN. I want to ask Mr. James just one question. How many of the new aircraft are leased these days. You didn't mention leasing in your testimony.

Dr. JAMES. Yes, Senator. For the aircraft that are in the fleet now about 25 percent are under a leasing arrangement.

The CHAIRMAN. 25 percent.

Dr. JAMES. Yes; the debt or the capitalized leasing debt would represent about 25 percent of our investment.

The CHAIRMAN. Senator Long.

Senator LONG. Thank you, Mr. Chairman. Let me ask this question.

It seems to me that we may vote to get you what you are asking for. I'd like to urge that the other guy benefit too. For example, under the law, you can get an extra 1 percent for your employees under an employee stock ownership plan.

And, I would just ask if your people would be willing—if we get this bill—to place some of this amount into an employee stock ownership plan? Now, as far as I'm concerned if you're worried about the complexity of it, it would be all right with me if you put that amount into a reserve for 2 or 3 years, and let it build up and vest it in the employees. Do you think your industry would object to giving this spirit of good will to everyone? They would say, well everybody benefits from it, including the employees.

Later on in the day, we're going to have some people from Continental Airlines testify. They are very enthusiastic about employees stock ownership. They believe they have more productivity right now.

Dr. JAMES. Senator, I can't speak for our individual airlines as to what their positions might be if they were asked—with regard to ESOP, but indeed, you've cited one outstanding example in Conti-

nental Airlines and the efforts that are being made there on the part of the employees.

I think that under deregulation, now, particularly as we progress more toward full deregulation that we're finding the carriers and the employees coming closer together in consideration of such plans. That's only a generality, but I think its possible it may lead to more specific arrangements at a later date.

Senator LONG. Well, a time or two I've tried to shame a few major companies into putting their employees in on the benefit that we vote, the company as well as employees.

I said one time to one of the major employers that if I were a labor union person working on the other side of the fence, that's one of the things I'd use to help organize that company. I'd be saying well, look, let me show how little these people care for you employees—I mean that boss you've got over there, he could buy you some stock in the company and it would cost him nothing. Nothing, maybe a little legal expense to set up an employee stock ownership plan and you workers are supposed to get some benefits out of this thing.

That situation reminds me of that old dog we used to have in the barnyard. We would put some food out there for the dog and he wouldn't eat it, but you let those chickens start pecking on that food and he would ferociously run them off, because he wasn't going to have them pecking on his food, even though he wasn't hungry and the chickens were.

Now, it just seems to me that this is a fair proposition. And employers could say, well, look, I'm an employer, but I'm for this other guy too. And when some of us get ready to seek reelection, there are a lot more of those employees that vote than there are of you lawyers and executive officers, and we would kind of like to have those votes be counted for us too. We'd like to see them be a part of this operation. We'd like to have them in on it.

Would you mind exploring that with your people and see if they would object too strongly?

Dr. JAMES. No, not at all.

Mr. SNOW. Thank you, Senator. I think it's an issue though that goes well beyond refundability of investment tax credits. It's a far more far ranging issue.

The CHAIRMAN. I wasn't talking about a package.

Senator LONG. Basically, I have many times quoted Bob Kerr who would have been Chairman of this committee had he lived. He used to say he was against any combine he wasn't in on. [Laughter.]

I'm just saying that it wouldn't be a bad deal at all to put the workers in on it. A lot of good companies have these plans, particularly capital-intensive companies—all of those privately-owned utility companies, they have such plans. In fact, they can criticize the oil industries, but I think practically all the majors from Exxon right on down, have put it in for their employees, and isn't your activity reasonably capital intensive?

Dr. JAMES. Very much so.

Mr. SNOW. Yes.

Mr. PEABODY. Yes.

Senator LONG. So that the investment credit would be pretty good, I think, a pretty good deal for the employees. There would be something significant there.

Mr. PEABODY. Senator, so you'll think well and happily of the domestic steel industry. We have a number of companies that have that and variations of it.

Senator LONG. Well, I recall when I first got the thing going, many people said it was a crazy idea. But those who have tried it, a lot of them are reporting back that it brought a better employee reaction. You just talk to people, now you just go to your favorite investor-owned utility company. They are very enthusiastic about it now. They say it's a good idea, it's working very well. It helps to create a good attitude on behalf of the employees, it makes them feel that they are aboard, they are part of what's going on in the company.

Mr. PEABODY. Senator, it will make them feel happier when their shares begin to go up when you here adopt the administration's tax program.

Senator LONG. Well, now it may, but especially if there is something in there for them. You know, when we look at what this capital creation has brought, there should be something in there for the worker as well. We shouldn't forget him.

I recall when we first got this thing going, an executive officer of one of the big steel companies, I won't call the company's name, we don't want to embarrass them or him, but he said do you realize how little that means. For my workers that would mean $39 per year.

My reaction to that was well, I'd hate to have to meet with those employees some time and say that I was the guy that made this decision and that I turned this program down—even though it didn't cost us anything, I turned down a $39 a year for employees.

If I was a guy fighting you on the other side of the table, and I was trying to recruit guys to join the labor union, I'd say now see, little though it may be, it was too much for your employees, and so it will be good, I think, when the Congress tries to do something to benefit the workers that management go along.

You know, it's going to get more and more lonesome not to be people who are looking ahead and selling their employees on the idea that what's good for management is good for the companies and vice versa.

You know, American Telephone & Telegraph is a pretty darn big company, I think better of them now than I did many years ago. [Laughter.]

They have it. General Motors had it. Exxon had it; you can find a lot of people in other business that have it, and it's going real well. I would just like for you to talk to your people about it and see if they would be willing to give it some sympathetic consideration.

Thank you.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman. I just want to assure you that at the rate we're going today, I have no intention of living long enough to be chairman of this committee. [Laughter.]

The CHAIRMAN. I didn't think I would either.

Senator DURENBERGER. I think Russell is bound to make George Malones out of both of us today.

Let me just say that I think some of the best things about refundability that was probably said this morning when all of you were here for that conversation, many of them were said by the person who has been talking this subject, as he has been talking ESOPS, for a long, long, long time.

One of the things that has impressed me about this issue, is that I came into it where I think all of you came into it, and that is in looking at the infrastructure in this country. I mean, it seems to me that we can do all of the budget cutting and tax reforming and all that sort of thing, and we're still not going to have a healthy economy in this country, unless we really address the issues of what has happened to the basic infrastructure in this country. And that means energy, and that means transportation and it means auto and steel and a variety of these very basic industries.

So, the effort, I think, that we put in here to look at packages and dollars and try to divide things so that we treat everybody fairly, certainly has to take into consideration that in addition to the arguments for winners, losers and things like that, that one of the main arguments to be made for special tax treatment in the infrastructure area, is what we have to do to turn the economy around.

Now, there is allegedly, and I guess we're going to hear about this a little bit later, an institution that's grown in this country to take care of the problems of airline, steel, rail, and so forth, and that's the leverage leasing industry.

I first heard about it after I went home and made some speeches on the rail deregulation to have some competition in the rail industry, and I talked about refundability and some banker came up to me and said, "My gosh, I'm making all kinds of money leverage leasing, I don't want you to put me out of that business."

Well, if it's that good of an institution, perhaps we should raise the question, why do we have to worry about refundability, and I'd like each of you to comment on whether or not the alternative of leverage leasing can provide the same benefit for the company as you represent, the companies that we've been talking about as the RITC.

Dr. JAMES. Senator, with the airlines, as you heard a moment ago, when I answered Senator Dole's question, we have a considerable amount of our debt in leasing at this point. Nearly 25 percent.

So, we've been using this form of financing very actively over the last decade.

It is, however, not the No. 1 choice for financing. We would be much better off if we were able to make a reasonable profit so that we could buy the equipment rather than lease it.

Leasing and leverage leasing in particular, means that you are giving up about half of the investment tax credit benefit, because half of it is going to the owner or lessee of the equipment and you may get the equivalent of about half of it back in terms of the leasing charges over a 15- or 16-year period, in the case of an aircraft.

In addition, you lose the residual value or the salvage value of the aircraft which is not unimportant to us over a period of time.

We, on balance, feel that ownership is better than leasing and leasing is generally used when we do not have the ownership option. We would much prefer going back to ownership and therefore the full ITC credit.

Senator DURENBERGER. Before we get the response from the other two panelists, what would your response to the chairman's question have been say, 5 years ago or 10 years ago or 15 years ago, on terms of the industry. You said 25 percent is leased today.

Dr. JAMES. Leasing, in the late 1960's was brand new to us, essentially a very nominal amount, if any were done prior to the mid-1960's. We began in the late 1960's and we picked up very actively then throughout the 1970's when our overall financial performance was only about half of what it should have been.

Senator DURENBERGER. Thank you.

Mr. SNOW. Senator, the same answer, essentially. Leasing is very important to the railroad industry, my railroad, and the leverage leasing is certainly an adaptation to the fact that we can't get the full benefit of the investment tax credit and we share the benefit with others. Obviously, it's better to get the advantage of the full 90 cents than to be paying 94, 95, 96 and through the leverage leasing a lot of resources get tied up in lawyers, accountants, auditors, and so. You lose the residual value. It's just a lot less efficient way to go about providing the party who is supposed to receive the benefits with the benefits in what we're talking about in your bill.

Mr. PEABODY. I would share that thought Senator. Leverage leasing is a scheme. It's for a variety of reasons why you use it including financing, for financial statement purposes, that it is essentially used when you're so damn poor that you can't afford for one reason or another to buy it outright on your own.

It's a scheme, it's a device, it's not the way to operate if you can avoid it.

Senator DURENBERGER. Thank you.

The CHAIRMAN. I was just checking. As I understand the cost of the investment credit other than ESOP, rehabilitation of structures and energy, this way you want about $16.5 billion. It's a tax expenditure, I'm not certain that that is a proper use of that phrase, but I'm just wondering what additional cost would it be to the suggestion by maybe not the panel, but I think Dr. James was talking specifically about refundability.

Dr. JAMES. I'm sorry, I don't quite understand Mr. Chairman. What additional cost over and above the refundability?

The CHAIRMAN. No, what would your proposal cost, I mean if we accepted your statement.

Dr. JAMES. Oh, I see. I believe we go back to some figures that Dr. Walker had presented this morning in which he indicated for most industries that have suffered losses and have built up unused credit that there would be about $3 or $3½ billion of unused credits. If they were refundable now or over time they might run say, over a 5-year period, something on the order of $700 or $800 million a year. If it were done immediately it would be $3 to $3.5 billion.

The CHAIRMAN. Where do we find the $3.5 billion or the $800 million. Do you have a proposal for that.

Dr. JAMES. I think that you need to keep in mind two things, sir. One is that the credit is designed not to be inequitable, which it is at this point between those who make money and those who don't. It's designed to stimulate investment.

In the case of the airline industry, we have the potential immediately of putting another $4 billion into the economy next year and the need to do so. And $90 billion over the next 10 years.

The money would be coming back as far as the revenue impact is concerned as we invest $4 billion. Each of those $4 billion creating some 60,000 jobs as I indicated before. Obviously, building up the tax base—there would be an approximate offset, if not a surplus, that would be built out of it eventually.

Mr. SNOW. Senator, I was going to make the same point with respect to the railroad industry. There is a number of locomotives and cars that aren't being purchased today. There's a lot of track structure not being put in. There a lot of railroad employees who are not at work. There is a lot of activity not being undertaken. There are jobs to create in the supply industries and in the railroad industry that don't exist today that would exist and would have a feedback effect on the tax system.

Now, nobody can precisely identify what that—of supply is, but its got to be positive, its got to be significant and I would align myself with——

The CHAIRMAN. Are you saying that it wouldn't cost anything—like the Roth-Kemp——

Mr. SNOW. I'm not saying that Senator, but I'm saying that—and some significant feedback from it. I haven't worked those numbers, but we have had some discussions with the staff committee on that and I think there is growing consensus that the feedback is pretty sizable.

Mr. PEABODY. Senator, we are here to support 10-5-3. We are here further to support the administration's two bill approach.

When we get to the second bill, there are a number of things that we would like to suggest to you. One is refund of the investment tax credit and Senator Durenberger has an approach to that which makes a considerable amount of sense to us.

A couple of other things at the appropriate time we'll speak to—with regard to the investment tax credit, you mentioned maybe a $16 billion pool. The number I've heard is more like $13 or $14 billion. But, whatever, it is the 5 or 6 heavy capital intensive industries that Senator Durenberger's bill mentions, steel, mining, air, automobile—our belief is that that accumulated pool is about $3.5 billion depending on how you phase in it. Whether you phase it in over a period of years, whether you go back as Chairman Rostenkowski mentioned in his speech the other day, over a period of time, there are a variety of ways that you feather the cost.

It obviously has a revenue impact, but equally obviously in these industries that we're speaking of today, it's going to be going into industries that are capital intensive who will use it for equipment to modernize.

The CHAIRMAN. Well, I don't support the clean bill approach, I assume the others support the two bill approach.

Mr. SNOW. We do, Senator. But, if there is going to be a second bill, we would like to see the refundable tax credit given serious consideration.

The CHAIRMAN. Dr. James?

Dr. JAMES. We would, yes.

Mr. PEABODY. Our strength is as the strength of 10, Senator. [Laughter.]

The CHAIRMAN. Well that's 10-10-10. [Laughter.]

We're making progress. If we do all these things on the first package there won't be anything left for the taxpayers, and the individuals, the corporations will probably get most of it though you don't do as well as I think you should under the ACRS. That's the problem we have and I don't know whether it has been resolved.

Mr. PEABODY. Senator, there is nothing more important to the domestic steel industry than ACRS. To get away from that ADR system of 15 year lives; it is astonishingly bad for the domestic steel industry.

The CHAIRMAN. As I understand, the administration still feels very strongly about separate proposals. The first bill will provide ACRS, some marginal rate cuts and, maybe, lowering the maximum rate of 70 percent to 50 percent. I'm not saying this is the final administration view. There are other small little packages, large dollar amount, but not many different provisions followed up with the second proposal with some revenue obviously or it wouldn't be any good to bring it up.

We would have to have all the competing forces including the three gentlemen before us and others and we would have to make the decisions in the House and Senate on how we're going to spend that, divide that or whatever. I appreciate it.

Do you have any further questions, Senator Long?

Senator LONG. What is it going to cost to have an employee stock ownership. I didn't ask, but that's hardly anything. But it's that or the refundable tax credit or all the rest of it, I just find myself asking "what has it cost us up to now?"

I would say trade, tax, regulatory policies have made us dependent on the Arab world for our oil, have made us dependent on the Japanese for 25 percent of our automobiles—has made us import all kinds of things that we could just as well be exporting.

What is the cost to us to have all those thoughts of—bidding and counterproductive labor—what do you suppose all that junk has cost us, in fact, what does it cost us to have a lot of environmental policies—that Alaskan pipeline cost 10 times what it was supposed to cost and for the last 4 years we wouldn't give somebody a lease to go out and drill for oil, what do you suppose all that costs.

Mr. PEABODY. Senator, what that has cost in terms of the domestic steel industry, is an industry that was the world class benchmark up until the middle 1960's and now is running desperately hard to catch up with the Japanese.

The reality is that these tax policy changes, the environmental policy changes, the trade policy changes that we have spoken of to you gentlemen before are desperately important to the domestic industry, the consequences of the existing policies have been to facilitate the depression of the domestic steel industry.

Senator LONG. Just what it has cost us—you think in terms of what it has cost us not to keep up with the Japanese and the West Germans in terms of productivity in the last 3 or 4 years, would make what you are asking for here sound like peanuts.

So, that when you think of it in terms of doing for the country what it ought to be doing—we can't afford not to.

Mr. PEABODY. That's why we feel so strongly, Senator that there is nothing in this room that isn't made out of steel or made out of an instrument of steel. There is nothing in our industrial world of today that isn't dependent upon steel.

These changes in the capital recovery area, for instance the changes in the trade law, that's what we need.

Senator LONG. I hope you're not including people in the generality of that statement. [Laughter.]

Mr. PEABODY. Senator, we employ 580,000 people. They are the best steel workers in the world.

[The prepared statements of the preceding panel follow:]

Statement of George W. James
Senior Vice President-Economics and Finance
Air Transport Association of America
Before the Committee on Finance
United States Senate
On the Need for Capital Recovery and Investment Incentive Legislation
May 19, 1981

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is George W. James. I am Senior Vice President-Economics and Finance of the Air Transport Association of America, which represents the scheduled airlines of the United States.

The U.S. scheduled airlines believe that an improved investment climate is essential to increase productivity, reduce inflation, create jobs, improve energy efficiency, and improve our ability to compete in the international marketplace. The questions you are considering -- the timing, nature and long-run structuring of tax legislation -- are crucial to the efforts to restore strong economic growth with high employment and stable prices.

The U.S. air transportation system interacts with the nation it serves on several levels: as a supplier of services that reduce production and distribution costs and stimulate market development; as a supplier of public service that uniquely meets the requirements of the travel market for expedited and reliable transportation; as a market for the products of U.S. high technology industries, which, in large part, enables the U.S. aircraft industry to maintain a position of supremacy in the world market; and as a vital augmentation of national defense needs. This system produces substantial benefits -- benefits that will be lost if the growth and productivity of air transportation is curtailed or reversed. The nation more than ever requires a modern, fast, frequent and reliable air transportation system, and the airlines must invest many billions of dollars to assure that this national need is met.

AIRLINE INVESTMENT REQUIREMENTS IN THE 1980's

New technology replacement aircraft for the U.S. airline fleet are urgently needed throughout the 1980's. Because of the long lead and delivery times involved, fleet planning decisions should be made now and orders placed as soon as possible if the important benefits of the new technology are to be realized fully during this 10 year period of most urgent need. In view of the huge investment cost and serious questions about the adequacy of available airline industry resources, fleet planning decisions will be deferred, and the level of orders could be sharply reduced unless capital recovery and investment incentive legislation is enacted.

Because of the complex, high-technology character of modern transport aircraft and support equipment, the airline industry requires an enormous ongoing capital investment for equipment acquisition and modernization. A single DC-10 or L-1011 aircraft now has a price tag of about $50 million -- equivalent to the cost of a 20-story office building.

In 1980, the airline industry investment in new equipment was $4.0 billion and exceeded the investment of the steel ($3.3 billion), aluminum ($3.1 billion), and rubber ($1.7 billion) industries. These industries are traditionally viewed as heavy investors in the capital goods sector of the U.S. economy.

Large as the recent level of airline investment has been, it will be substantially exceeded by the new levels of investment required during the decade of the 1980's. The industry's required investment for the decade ending in 1990 will approach $90 billion, or an average of about $9 billion per year.

Airline industry investment in new technology will contribute significantly to other essential national policy priorities. It will create thousands of jobs in the aircraft and engine manufacturing and supplier industries. And with enhanced productivity, new technology aircraft will help offset inflationary pressures on the price of air transportation to airline passengers and shippers.

AIRLINE INDUSTRY RESOURCES

During the period 1970-1979, the airline industry earned a profit margin of only 2.1 cents on each dollar of revenue, compared to 5.1 cents for U.S. industry in general. The average return on total investment (including long-term debt) was only 6.3 percent, compared to 10.2 percent for U.S. industry. In the two most recent years -- 1979 and 1980 -- the results were particularly discouraging, with net profits of only $400 million in 1979 on record revenues of $27 billion. In 1980, net profits dropped to $17 million despite a significant increase in revenues, while operating losses totaled $226 million -- a record loss.

Airline industry earnings over the past decade have been directly affected by changing national economic conditions, resulting in ups and downs in traffic growth, by explosive increases in operating costs, especially fuel, and by an inability to pass through costs dollar for dollar to consumers in periods of inflation and recession. New flexibility made possible by the Airline Deregulation Act, tighter cost controls, and a general industry belt tightening hold the promise for an improvement in the industry's economic posture during the period ahead. However, attaining an airline industry return on investment high enough, and on a consistent basis, to support an investment approaching $90 billion will be exceedingly difficult.

Airline fuel costs in 1980 amounted to an estimated $9.5 billion, compared with $1.3 billion for 1973, when the fuel price surge began. In short, airline fuel costs have risen over 700 percent since 1973, while consumption has remained relatively stable.

Fuel now represents over 30 percent of airline cash operating expenses. The escalation in the price of fuel is expected to continue and will impact heavily on airline earnings in the decade of the 1980's.

The airline industry would need an average annual corporate return on investment (ROI) of 13 to 15 percent to meet the capital requirements from 1980 to 1990. Over the past five years, the airline industry ROI has averaged nearly 9 percent, and was only an estimated 6 percent in 1980.

THE NEED FOR EFFECTIVE CAPITAL RECOVERY AND INVESTMENT INCENTIVE LEGISLATION

Significantly improved airline industry earnings are dependent upon a healthy and growing national economy, restored consumer confidence, increased employment and productivity, and lower inflation rates. Immediate, positive tax policy changes are imperative in attaining these goals. The airlines believe there is an urgent need for early enactment of effective capital recovery and investment incentive legislation, both to enhance airline investment capability and to stimulate the national economy.

The proposed Accelerated Capital Recovery System (ACRS) represents such a positive tax policy change and the airline industry endorses it. The ACRS will help the serious capital recovery problems facing American business. However, it will do little to meet the current needs of those business enterprises which are marginally profitable, intermittently operate at a loss, or are newly developing companies. Nor does it meet the needs of industries, like the airline industry, that experience wide cyclical variations in profitability and have very heavy demands for capital investment. An improvement in the investment tax credit program is urgently needed to deal with the problems of these companies and industries.

The investment tax credit program was designed to encourage business to invest in new plant and equipment to enhance productivity and employment. The credit is earned by making an investment. Credits earned are used to reduce taxes. Profitable companies have the cash benefit of the credit paid to them

immediately through a current reduction of income tax liabilities. On the other hand, unprofitable or marginal companies do not receive immediate benefit of the credit, and may never receive it under existing law. Such companies need the benefit of the credit to reduce the cost of acquiring capital equipment. Thus, the current investment tax credit program should be modified in order to make it more effective and more equitable. For example, the airlines stand to lose a substantial amount of earned credits as a result of the current earnings outlook of the industry. The airlines need the ability to use both prior earned credits and new credits as well. At the end of 1980, the airlines had $680 million in earned but unused credit. The solution to this problem is to provide for the refundability of earned but unused investment tax credits.

In summary, the airline industry of the United States faces an extraordinary investment need in the 1980's totaling nearly $90 billion. An investment of this magnitude is essential to maintain an efficient and reliable national air transportation system. Such an investment is fully consistent with several important national policy objectives, including energy efficiency improvements, greater productivity, job creation, and environmental progress. However, the required airlines investment will not be possible in the absence of significant improvements in the national economy, airline earnings, and investment incentive opportunities.

The airlines believe that effective capital recovery and investment incentive legislation is needed and the proposed ACRS represents a substantial step in the right direction. However, a more complete, effective and equitable capital recovery system should incorporate investment tax credit improvements, including a provision providing for the refund of the earned but unused investment tax credits.

American Iron and Steel Institute

Written Statement Submitted by
American Iron and Steel Institute
to the Committee on Finance
United States Senate
May 20, 1981

This statement is submitted on behalf of AISI and its 66 domestic member companies which together supply about 92 percent of the iron and steel which is produced in the United States. These companies employ more than 568,000 workers and have over 800,000 shareholders.

The domestic steel industry believes that the passage of the President's "Program for Economic Recovery" is essential in order to restore confidence in the economy and achieve the goal of reindustrializing America. AISI fully supports that program. We specifically support and urge prompt action by this Committee on the capital recovery proposal, which is the core of the Administration's Accelerated Cost Recovery System (ACRS) with minor modifications which are set out below.

The United States needs a strong, healthy domestic steel industry. Our world as we know it today could not exist without steel, and that therefore dictates a strong, healthy domestic steel industry.

The domestic steel industry has problems - they are now well known. But the industry has the ability to overcome these problems if the government policies which have substantially contributed to our present difficulties are changed. Early in 1980 - over a year ago - AISI published "Steel at the Crossroads - The American Steel Industry in the 1980s." In that report we spoke to the need for increased modernization of the domestic steel industry and pointed

out that the basic problem of the industry has been low profitability - a condition which in large measure is the result of government policies related to capital formation, international trade, and regulatory burdens including environmental policies. A number of other studies released in the past year, including reports by the General Accounting Office and the Office of Technology Assessment have agreed that a principal problem of the domestic steel industry is capital formation and that resolution of that problem is dependent upon changes in government policies in tax, trade and environmental areas. Similarly, the September 1980 Steel Tripartite Committee (made up of representatives of the Government, the United Steelworkers Union and the steel industry) report also concluded that the industry is faced with a severe capital shortage, and that changes in Government policies would be required in order to mitigate that shortage.

The need for changes in our capital recovery system in the tax laws in order to facilitate the further modernization of the domestic steel industry, is widely recognized by those who have studied the condition of the industry. Except for cement, no other major industry in this country has as long a recovery period as steel manufacturing, and in no other major steel producing country is there a longer recovery period. Canada, for example, which has a strong, profitable and modern steel industry permits the recovery of steel equipment capital cost in 2½ years - one reason why across Lake Erie a new greenfield steel plant has been constructed by a Canadian steel company, and none has been built in this country for over 15 years.

U.S. tax depreciation policy has over-emphasized the physical life of steel plant facilities and along with governmental policies in other areas has seriously impeded the industry's ability to take advantage of advancing technology. The steel industry is required to write off the original cost of plant and equipment over a period of 12 years. Depreciation regulations reflect the so-called "useful life" concept and ignore the devastating effect of inflation on an industry whose inherent capital intensity has been aggravated by heavy environmental requirements.

The steel industry strongly supports the ACRS concept of capital recovery which would open a new era of governmental cooperation with industry with special recognition of the need to improve productivity. This bill embodies many of the features that American steel companies consider essential. It provides for more rapid recovery of capital investment made in productive assets; it eliminates the concept of recovery over the useful life of the assets; and it greatly simplifies the present system by establishing only three classes of capital investment for most steel assets. Over time this legislation would help the steel industry generate the cash flow it needs for the facilities which need to be installed.

The ACRS will not in the short term be of substantial direct benefit to the domestic steel industry. Because of several years of depressed earnings, industry members have accumulated carryovers of operating losses and investment tax credits which, until they are used in future years, will result in a deferment of the full benefits of ACRS. The steel industry is firmly convinced, however, that the

total economy, including the steel industry, will be best served by the adoption of ACRS as quickly as possible. The steel industry will benefit indirectly in the short term by the prompt adoption of ACRS since its adoption will stimulate increased purchases of steel for capital goods by our customers with the consequent benefit not only in funds available to steel companies for investment but also in the increased productivity which new plant and equipment will bring to our general economy.

In the longer term ACRS will also provide major direct support for steel industry modernization. With inflation, even moderate inflation, ACRS does not permit full recovery in constant dollars. Nevertheless, the impact of inflation on real capital recovery is much less under ACRS than the present system because the recovery period is shorter.

After the initial phase-in period, the cumulative benefit of capital recovery from the ACRS compared to the existing ADR system, assuming the industry achieves a reasonable level of profitability would be substantial. For example, assuming a constant annual level of investment, the cumulative capital recovery for a 5 year period under ACRS will be almost double that of the present system. For an industry which has been spending well over $3 billion a year on capital investments and which still has - as stated by the Steel Tripartite Committee - a capital shortfall of $2 billion or so a year, this change can be of very substantial benefit to the efforts of the industry to accelerate its modernization.

We do believe that the ACRS could be improved in two important

areas and we strongly urge this Committee to adopt the following measures:

1. There should be the flexibility built into the recovery system to permit taxpayers to defer allowable capital recovery and take the benefit in a later year. Due to the prolonged depressed state of earnings of some of the companies, it is possible that the intended benefit of capital recovery deductions could be permanently lost if they were mandatory because of extended periods of operating loses. Flexibility is necessary to insure that the benefits will not be lost to these companies as they return to a higher level of profitability.
2. The capital recovery and related investment tax credit should be applicable when funds are spent in all cases and not just in those cases where long term construction is involved. The arbitrary two year period rule simply provides for administrative complexity and unnecessary controversies with the IRS.

Various previous proposed Capital Cost Recovery Acts contained these provisions and we urge that they be reinstated in the current proposed bill.

Important Related Items for Future Consideration

A substantive improvement in the capital recovery period has long been the principal legislative objective of the Institute in the tax area. We believe that the ACRS proposal with the recommended modifications is essentially the type of capital recovery improvement

which is critical to the steel industry.

The capital recovery period is an essential element of the broader concept of capital formation. At the appropriate time, either if this Committee decides to expand upon the scope of the Administration's proposed Economic Program or as part of a more comprehensive tax bill later this year, we urge that the Committee carefully consider several items which are also of vital interest to the steel industry. In all cases the items, which are detailed below, are directly related to capital formation, and would complement the overall objectives of the Administration.

More Equitable Availability of Investment Tax Credits

The problem of earned but unused investment tax credits in the steel industry is one of relatively recent vintage. At the end of 1980, there was a total of approximately $800 million of earned but unused credits available to steel companies, most of which has been generated since 1977.

The problem has arisen primarily due to increased capital spending during a time of depressed earnings. By way of explanation, according to statistics compiled by the Institute, average capital expenditures of member companies increased by 35% during the period 1976-79 compared to 1973-75, while net income decreased by 46%. This simply means that there were more investment tax credits earned and less tax liability against which to use them. Therefore, a substantial amount of credits could not be used currently even though the maximum amount of tax liability against which the credit could be applied was increased by 10 percentage points annually from the initial level of 50% in 1978.

The present statutory limitations on the utilization of investment tax credits, i.e., a percentage of the computed tax after deducting certain other credits, denies realization of those credits when a company is faced with an adverse economic situation. For most companies in the steel industry, the effects of escalating production costs, substantial unfairly priced imports, and rising capital and operating costs for environmental facilities, have severely reduced profitability and cash flow for the past several years. As a result, substantial amounts of unused investment tax credits have been accumulated by many companies at precisely the point in time when infusions of cash would be of tremendous benefit. Ironically, some companies are currently deferring or cancelling capital expenditure programs for lack of cash while at the same time they have already earned substantial investment tax credits which will be realized as a cash benefit sometime in the future. More rapid realization of these credits by permitting prompt refundability, or by permitting excess credits to be carried back to offset prior tax liabilities on an expanded basis would help to place much needed cash in the hands of the steel industry now rather than several years from now.

Several factors support this position. First, as to the use of existing investment tax credits, it must be recognized that these credits have already been earned by virtue of substantial capital expenditures already having been made. Furthermore, in the majority of cases, their realization now is merely a trade-off

against utilization, under existing law, sometime in the future.

Second, on the broader philosophical issue, the United States has determined that economic growth and stability can be promoted by encouraging capital expenditures for reindustrialization through tax policy. The investment tax credit is one tool of tax policy developed to induce firms to invest in capital goods. Unfortunately, realization of those credits hinges on the size of pre-credit tax liability which, in turn, hinges on a reasonable level of profitability from other prior investments not the investment in question. It seems logical that if capital expenditures for reindustrialization are desirable, then the incentive (investment tax credit) should be made equally available to all firms that make the qualifying investments. There is no apparent reason why the earnings from prior investments (or lack of earnings because of the lack of prior investment) should be determinative of the benefit from the incentive. The importance of this conclusion is self evident when the investment tax credit itself could be a major source of future investment capital which is critically needed by many companies in the steel industry.

Corporate "Minimum Tax"

The minimum tax on "tax preferences" as it is applied to corporations is an area of tax policy which was enacted without giving adequate consideration to its impact. In practice it has had a narrow and clearly discriminatory impact on selected industries, not because these industries have an excessive usage of so-called tax

preferences but because of their low profitability. In short, the tax penalizes those industries who are least able to pay and is regressive. It has been a deterrent to capital formation, frequently in those capital intensive industries such as steel and mining, where there is a demonstrated need for investment in order to modernize and improve productivity.

The fiscal and economic policy objectives of the United States in future years will not be well served by a continuation of the minimum tax as it applies to corporations. In view of the capital formation goals of the Administration and many members of Congress and the increasing awareness of the importance of employment, economic activity, and improved productivity which is derived from capital, the capital eroding minimum tax on corporations can no longer be justified. It is time to critically reexamine this area of tax policy and enact legislation which would provide for its repeal. Whatever merits may exist for the imposition of some form of tax on individuals to address perceived abuses, a persuasive case has never been made nor even attempted to demonstrate the need to impose the same type of tax on corporations.

The minimum tax on corporations raises relatively small amounts of revenue -- $267 million in the last year for which statistics are available - 1977. The estimate for 1981 is $370 million. However, the tax falls heavily on a few industries -- primarily mining and steel manufacturing which are critical to the desired expansion of the economy. The minimum tax on corporations is imposed at the

rate of 15 percent on the excess of preference items over regular income tax paid. Thus, as regular income tax is significantly reduced because of reduced profitability the preference items, which arise in the normal course of business, while perhaps not large in relation to the size of the corporation, may nevertheless exceed the regular tax and trigger a 15 percent minimum tax thereon. Incidentally, this may occur even though the company may have a regular tax liability in the tens of millions of dollars. The minimum tax paid by steel companies does not grow out of use of tax shelters to offset unrelated income. Steel companies which pay minimum tax do so because their profits and, therefore, their regular tax liabilities are relatively low in relation to their preference items which arise in the conduct of their business.

An unfortuanate and perhaps unforeseen effect of the minimum tax is that it reduces the benefit to these particular taxpayers of existing capital cost recovery and incentive items. For example, the minimum tax on a corporation can have the effect of creating an effective tax rate of about 33 percent on capital gains, rather than the 28 percent rate specified by the Congress. In addition, it also can effectively reduce the investment tax credit from a value of 10 percent of the investment to 8½ percent. It can also reduce the effect of rapid amortization of pollution control equipment to the point that corporations are sometimes better off not using this tax incentive. Similarly, it will, for certain companies, dilute the incentive for productive investment which is sought from

the accelerated cost recovery system under consideration by this Committee.

The Institute believes strongly that the minimum tax on corporations is not in the national interest. We are satisfied that the minimum tax on corporations impacts adversely on capital formation and cash flow in ways that were never intended by the Congress. It does not raise large amounts of revenue; it is paid, by and large, by companies of low rather than high profitability; it hampers our national self-sufficiency and ability to compete; and it should be repealed. We urge your careful attention to the inconsistency of this regressive tax with the goals of the President's program.

Energy Tax Credits

The Energy Tax Act of 1978 was enacted by Congress to promote conservation, encourage the use of energy effective equipment and to encourage the conversion of industrial processes from the use of oil and natural gas to the use of alternate fuels. Unfortunately, regulations issued by Treasury under this legislation have very narrowly interpreted the types of equipment and conversion processes which qualify for the additional credit. We believe that legislation should be expanded in this area to insure that the necessary incentives intended by the Congress are not negated. We especially believe that Congress should amend the current law to insure that the investments in major energy saving industrial processes, such as the continuous casting process in the steel industry, qualify for purposes of the energy tax credit.

Individual Rate Reductions

The Institute does not normally take a position on individual tax matters. However, we believe that the type of broad based across-the-board tax reductions recommended by the President are essential as a stimulus to individual savings, and capital formation and to provide meaningful relief from the increase in taxes caused by inflation and social security tax increases.

STATEMENT OF JOHN W. SNOW, SENIOR VICE PRESIDENT-CORPORATE SERVICES
CSX CORPORATION, BEFORE THE SENATE COMMITTEE ON FINANCE
MAY 19, 1981

Mr. Chairman, my name is John W. Snow. I am Senior Vice President-Corporate Services of the CSX Corporation. CSX Corporation came into being on November 1, 1980, as the result of the merger of two great railroads, the Family Lines Rail System and the Chessie System. With the merger, CSX became the largest railroad system in the country. While the bulk of our revenues and assets are in the railroad industry, CSX also has enterprises in real estate, oil and gas, cable TV, aviation, resort hotel, publishing, data processing and natural resources development activities. Today I will be testifying about the railroad portion of our business which in 1980 produced operating revenues of $4.5 billion as contrasted with operating revenues of $344 million from the other business enterprises.

I am pleased to have this opportunity to join with representatives of other capital intensive industries to testify in favor of making the investment tax credit fully available to companies which are now unable to use the full amount of their investment tax credits on a current basis. We, of course, support the Administration's proposals for accelerated cost recovery but my testimony will be directed to recommended changes in investment tax credits.

Let me speak first of my own company, and in some detail. Later I will offer a few comments about the railroad industry generally.

The bulk of CSX Corporation is comprised of two railroad companies: the Seaboard Coast Line and the Louisville and Nashville, which with their affiliates form The Family Lines Rail System, and the Chesapeake and Ohio and its subsidiary, the Baltimore

and Ohio, which together with other subsidiaries form the Chessie System. Our projected capital expenditures for all these companies for 1981 are $908 million, and for the five years 1981 - 1985 aggregate $6.2 billion, an average of $1.2 billion per year. Thus, we expect to generate an average of $120 million of investment tax credit ("ITC") annually.

Our companies are not now able to use immediately the tax credits created by these large capital investments which are made year after year. At the end of 1980, we had accumulated a carryforward of unused ITC amounting to some $200 million. Under present law, we can use this carryforward credit to offset 80% of our tax liability this year, or 90% next year and thereafter. But using the carryforward this way means that our newly generated credit cannot be used currently: it can only be added to the backlog of accumulated carryforward, to be used in its turn in some unknown future year, where it will merely cause that later year's credit to be deferred. Thus, our current activity produces no immediate benefit so far as the tax system is concerned. We would pay exactly the same tax without our new investment as we pay with it, so our new investment gives us no current tax saving and hence provides little of the incentive intended by the ITC laws.

There is another serious consequence of our inability to make immediate use of the ITC we generate. It creates serious inequality between competitors. The present tax system gives one significant advantage to some railroads which can fully use their tax credit each year. Their taxable income is high enough in relation to their level of investment so that they are able to use all of their ITC currently to reduce tax liability. Consequently, they are able to buy all of their locomotives, cars, ties, rail, and so forth, for 90 cents on the dollar, whereas expenditures of others for the same purposes cost a full dollar.

Our proposal for solving these problems is to change the law to give us immediate use of the ITC we generate, at least insofar as this ITC results from new investments. Immediate use of new credits would obviously provide the full investment incentive and remove competitive inequality. In addition, we believe there is an excellent case to be made for immediate use of our accumulated carryforward instead of waiting for it to be used against future tax liabilities.

The process of investing in productive plant and equipment is a continuing problem of selection, of trying to choose from a multitude of worthwhile projects those which are the most pressing or which promise to yield the highest return after taxes. As is the case for most enterprises, there are more things that CSX would like to do than we can accomplish with the resources available to us. An infusion of cash would not only have beneficial direct results, but would also have a multiplier effect. We could undertake a greater number of investments. For these investments and also for those we are already making, using our own cash would reduce our need to borrow. This would in turn tend to raise our credit rating, lower our interest costs, and provide still further cash through the interest savings to continue multiplying these beneficial effects. Meanwhile, our investments would put money in the hands of workers and suppliers, with a further multiplier benefit to the economy as a whole.

In asking for more immediate availability of the credit generated, I do not mean that we expect to become in any sense a ward of the State. Since The Family Lines and the Chessie System took their present consolidated forms, neither has ever reported a net operating loss for tax purposes, with one small negligible exception for The Family Lines in 1975. Our problem is not that we have no taxable income, but rather one of not having enough income to absorb all of the ITC generated by our heavy capital investments. For the future, our forecasts indicate strong earnings, more than sufficient

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to absorb in due course all of our $200 million carryforward in addition to the average $120 million in credits we expect to generate in each of the next five years.

Thus, our proposal is simply that we and other taxpayers similarly situated should receive now the full amount of the credit which the present tax law will eventually provide us in future. We are not proposing a new tax expenditure, but are asking that the full tax credit be moved up in time and made available to us for reinvestment now. The early receipt of these funds will, I repeat, enable us to respond to the intended incentives and achieve competitive equality.

Let me emphasize that our proposal will also enable us to respond fully to the incentives intended by the various forms of accelerated capital recovery now under consideration. As is becoming generally recognized, there is an inherent conflict between the various tax mechanisms designed to encourage capital investment. One of these mechanisms is the ITC; in general it works very effectively, but its use is limited by the amount of tax before credits. The other mechanism is accelerated capital recovery, but it works by reducing taxable income and therefore taxes. By reducing taxes, accelerated capital recovery has the paradoxical effect of compounding the ITC problem and increasing the amount of the tax credits generated by these same capital investments which cannot be used by the companies which have earned them. The upshot for capital intensive companies is that they are likely to find themselves in a no win situation: the more they invest, the more ITC they generate and the less they are able to use it.

Although I am not testifying for the entire railroad industry, it is safe to say that CSX Corporation reflects in many ways the industry as a whole. Railroad companies diverge widely in profitability, by reason of the territory they serve, the types of traffic available to them, their past history, or their possession of natural resources

and other property. Some are well able to benefit by all of the incentives the tax system can offer; others like the CSX group are able to benefit substantially but not to use all of the incentives, while still others may well require aid beyond what the tax system can offer or even face dismemberment or liquidation. The two major railroad subsidiaries in CSX likewise diverge in their past and potential profitability, although they are basically strong. The C&O and the SCL have always been fundamentally strong and financially healthy. The B&O, however, was in serious straits when C&O took control of it in the early 1960s, and the L&N had its time of troubles in the 1970s. Restoring these railroads to financial health and full viability has required, and to a considerable extent is still requiring, large infusions of capital accompanied by a period of relatively low profitability. It is in this period that we, like other railroads in a comparable situation, really need the extra push over the hill that tax incentives can give us.

It is not my purpose here today to attempt to discuss in detail the various mechanics by which all taxpayers could be allowed, on a current basis, the full credit to which they become entitled each year by making qualified investments. I would like, however, to mention specifically one idea which seems to be gaining favor among many policymakers. That is to permit taxpayers who cannot use all of their credits currently to transfer them to other taxpayers who can use them. The particular merit of this idea is that it would allow the use of credits to be allocated entirely within the private sector without excessive government involvement beyond the normal audit procedure.

As a practical matter a very substantial amount of credit is already being transferred in the private sector by means of so-called leveraged leases. Leveraged leases, however, entail a high cost of compliance with complex technical rules established by the Internal Revenue Service, and require the transferring taxpayer to give up the residual value of his investment at the end of the lease term. For technical reasons they are not equally suited to all types of investment; while leveraged leases may be appropriate, for example,

for railroad rolling stock or for new airplanes, they would not help to open a coal mine. Permitting free transferability would greatly simplify these procedures, would preserve residual values for the investor who really initiates and pays for them, and would make the benefits of transferability equally available for all types of investment.

Transferability is one of several methods which could be used to make the investment tax credit fully available. We are convinced that a practical and efficient means of correcting the inequity in the existing system of investment tax credit can be found. We believe very strongly that the Congress should take steps to give the full intended benefit of the investment tax credit to industries like railroads which year in and year out make very large investments in right-of-way and equipment to maintain the basic rail network which ties our industrial economy together.

Thank you.

The CHAIRMAN. Thank you very much.

Our next panel consists of Paul Finfer on behalf of the American Association of Equipment Lessors, Barry Korn, on behalf of Computer Dealers and Lessors Association. I understand Mr. Healey is not here.

STATEMENT OF PAUL M. FINFER ON BEHALF OF AMERICAN ASSOCIATION OF EQUIPMENT LESSORS

Mr. FINFER. Mr. Chairman, members of the committee, my name is Paul Finfer. I am a member of the board of directors, and chairman of the Federal Tax Subcommittee of the American Association of Equipment Lessors, the AAEL, on whose behalf I am appearing today.

I am president of Beneficial Leasing Groups, Inc., a subsidiary of Beneficial Corp.

We in the AAEL thank you for allowing us this opportunity to testify in support of the business tax cut proposals in S. 683.

We believe that passage of legislation of this type is crucial to the revitalization of American industry. The AAEL represents the largest single group of capital equipment investors in the United States, a multibillion-dollar equipment leasing industry.

This industry now accounts for approximately 20 percent of all new capital equipment investment each year in this country, and currently has over $150 billion of lease receivables outstanding.

I would like to take a couple of minutes to explain the role of the equipment leasing industry and the overall national economy and then I will use the allotted time remaining to try to explain one of the technical modifications we would like to propose, which we believe will assist Congress in assuring that the tax benefits contained in this bill are utilized properly and efficiently.

Traditionally, the equipment leasing industry has operated as a major source of intermediate to long range financing and as the most cost effective method of financing capital assets for those companies that cannot fully utilize accelerated depreciation and investment tax credits on a current basis.

It accomplishes this by taking the tax benefits for itself and passing on their present value to lessees in the form of low rentals.

Additionally, through equipment leasing, corporations transfer these tax benefits through the judgments and disciplines of the competitive marketplace, without the added cost and inefficiencies of proposed Federal subsidy measures such as the refundable investment tax credit.

The leasing industry is very competitive and this competitive marketplace drives down rentals to a point where lessee users are provided the equipment they need quickly and at the lowest possible cost.

Equally important, the marketplace judges the economic viability and creditworthiness of these lessees. This traditional selectivity of the competitor free marketplace works to channel leased capital equipment to viable economic entities, as opposed to hopeless failing companies. And, in doing this, the equipment leasing industry works to maximize the effective use of tax incentives, making it a mechanism for acquiring capital assets that is both effective and efficient.

One of the modifications that the AAEL seeks is the addition of a new provision modifying two technical IRS tests that would artificially restrain economic efficiency in competition in the leasing industry.

In the wake of this or similar tax legislation, these two tests along with certain other requirements, which we do not seek to change define when the IRS will accord truly status to major leverage lease transactions which account for most of the dollar value in equipment leasing.

What the two technical tests would do in effect, is to restrain competition and keep rental costs artificially high even though the competitive marketplace after the tax cut legislation would accommodate significantly lower rental cost to equipment users.

This comes about because the two technical IRS tests totally disregard the economic value of accelerated depreciation and investment tax credits.

The whole point of the current tax cut legislation, however, is that accelerated depreciation and investment tax credits clearly do have economic value as an inducement to capital asset purchases.

There is nothing in sound economic policy or in the decided court cases that supports the two technical IRS tests that cause the problem.

We, therefore, ask that the two IRS tests be modified to allow an owner-lessor to consider these benefits of ownership as part of the economic substance of a lease transaction.

This request is totally consistent with the intent of Congress in the administration in proposing the tax cut legislation and, if passed, will result in improved efficiency for our industry and substantial cost savings for equipment users.

Thank you very much.

STATEMENT OF BARRY P. KORN ON BEHALF OF THE COMPUTER DEALERS & LESSORS ASSOCIATION

Mr. Korn. Mr. Chairman, Senators, staff, Mr. Chief Counsel, Mr. Minority Counsel, ladies and gentlemen, good afternoon. I'm Barry

Korn, president, of Barrett Capital & Leasing Corp. Thank you for the opportunity to express the views of the Computer Dealers & Lessors Association.

The computer leasing industry will be penalized if S. 683 remains in its present form. Our concerns and recommendations are:

One, sale and lease-back transactions are excluded from the benefits of the accelerated cost recovery deduction. This exclusion particularly hurts short-lived assets such as computers.

It is important to note that it is common practice in the computer industry for manufacturers to provide rental credits to customers to induce them to purchase their computers after a period of time.

Often, such companies are either not in a position to purchase the equipment or choose not to tie up their capital in this manner.

The third party computer lessor enables the user to enjoy the benefit of the rental credits through a sale and lease-back transaction.

Accordingly, we recommend language which calls for a 5-year transition period after which time the standard capital cost recovery provisions will be utilized.

During the interim period, we recommend the continuation of the existing ADR system.

Point 2. The proposed bill provides for mandatory use of accelerated depreciation. This forced acceleration will produce a financial hardship on small- and medium-sized leasing companies, particularly computer lessors. The retention of earnings is critical in capital formation and in building the base of equipment held for lease.

The utilization of ITC, therefore, is most important. Being forced to depreciate equipment more rapidly than economic conditions would otherwise dictate creates excessive depreciation which leads to reduced earnings and the inability to utilize the ITC on a timely basis if at all.

This problem is further compounded in the computer leasing industry. The use of a depreciable life for tax purposes shorter than that used for financial reporting purposes has often created confusion in the minds of lending institutions and stockholders.

It is incorrectly perceived that the resulting financial statements are overstated. To maintain capital formation in the computer industry it is important for our financial institutions to understand that our financial statements reflect realistic expectations.

Therefore, we recommend that S. 683 adopt language such as that in Conable-Jones, which provides that a taxpayer may deduct less than the full capital cost allowable and carry forward any amount allowable but not deducted.

Point 3. The intended increase in tax benefits resulting from the accelerated depreciation will not fully accrue to the lessee's benefit, unless Congress requires adjustment in IRS procedures issued in 1975, 7521 and 28.

Such an adjustment also would clarify other requirements of these procedures, like the minimum investment which are not supported by case law and which serve to discriminate against smaller equipment lessors.

We believe that 7521 and 28 are not in line with current market conditions, and impede capital formation in this country.

We recommend that the bill provide language to eliminate the requirements of 7521 and 28 with respect to equipment leasing transactions by corporate lessors.

Point 4. The proposed bill provides for a 10-year, straight line depreciable life, for assets owned by U.S. equipment lessors, but which are located in other countries.

This provision places U.S. lessors at a competitive disadvantage relative to foreign lessors.

We don't believe that it is the intention of the administration or Congress to place U.S. lessors in a weakened position.

This is a particularly sensitive issue to computer lessors due to the shorter life of computers relative to the proposed 10-year recovery period.

We recommend the elimination of those provisions from the bill which provide that such property be depreciated over 6 or 10 years rather than 3 or 5 years.

CDLA realizes the complexity of the issues you face in S. 683 and the intense time pressures which you are under. We have attempted to keep our proposals in line with the express purposes and simplicity of the bill. We respectfully request your favorable support of our recommendations.

Thank you.

The CHAIRMAN. Mr. Healey.

STATEMENT OF THOMAS J. HEALEY, MANAGING DIRECTOR, DEAN WITTER REYNOLDS INC.

Mr. HEALEY. Good afternoon. I am honored to appear before this distinguished committee. My name is Thomas Healey. I am managing director, investment banking of Dean Witter Reynolds Inc. and head of that firm's project finance group.

Dean Witter has acted as agent or adviser in more than 20 lease financings in the last 3 years representing in excess of $2.5 billion in assets.

The purpose of my testimony is threefold. First, to describe leasing and its benefits; second, to indicate the economic impact of the proposed ACRS on real estate and equipment leases; and third, to examine some implications of ACRS and leasing for the electric utility industry.

In a lease, assets are purchased by one or more investors (the lessor) and rented to a company (the lessee) for a substantial portion of the assets' economic life. Frequently, a large portion of the investment is financed through borrowings, thereby creating a leverage lease.

The tax benefits of the asset (depreciation and investment tax credit) accrue to the lessor as owner for tax purposes. In return for receiving these benefits, the lessor is able to charge a lower rent to the lessee. These savings can be substantial; in a representative transaction, the net present value advantage under current tax laws—to a company which cannot itself use the tax benefits—can be as much as $290,000 per $1 million of asset cost.

The transfer of these tax benefits through leasing is an important element of the present day capital market since many compa-

nies have substantial requirements for capital expenditures but are unable to utilize efficiently the resultant tax benefits.

Leveraged leasing is a practical alternative to refunding of investment tax credit, an alternative which is already available and in use.

Leasing promotes new capital investment in two ways. First, leasing lowers the net after-tax cost of investment to the ultimate user of the asset, the lessee, thereby promoting additional investment in plant and equipment. Second, leasing greatly expands the sources of financing available in the U.S. capital market by introducing a group of tax-oriented investors with sizable amounts of money to invest in lease transactions.

For a full taxpaying company, ACRS will make leasing less attractive by making ownership more attractive, particularly in the case of real estate leases since it is proposed that the lessor use a longer recovery life than would a company owning and occupying the structure directly.

However, for companies unable to utilize tax benefits in a timely and efficient manner, leasing is currently and will continue to be an attractive form of financing. As mentioned above, in a typical lease of a large plant, the savings today might be $290,000 per million dollars of asset cost. Under ACRS as proposed by the administration, this savings would increase to $320,000 in 1981 and would be $380,000 in 1985 when ACRS is fully phased in. Real estate leasing would remain attractive, but less so than under present law because of: One, the proposed personal tax rate reduction and, two, the proposed longer recovery period for leased—as opposed to owner-occupied—structures.

Let me turn to the impact of ACRS on the utility industry which I submit is particularly important, since many utilities, perhaps as much as one-third of the total industry, cannot use, on an immediate basis, even those tax benefits which are currently available to them.

We have talked today about the unused investment tax credits which exist in a number of industries. A recent Department of Energy study indicated that the electric utility industry as of the end of 1979 had $2.4 billion in unused investment tax credit.

Further, the capital requirements in the future for the electric utility industry are imposingly large. One study done for Dean Witter by Data Resources shows net external capital requirements of $30 billion in the next 3 years alone.

Because of this inability to use tax benefits efficiently, leasing can have a positive impact on utilities. These benefits should be further enhanced by ACRS. Leasing is a mechanism to transfer tax benefits from inefficient utility users to lessors able to use them and this promotes the introduction of new funds into the utility industry and holds down rate increases.

Finally, in adopting the proposed ACRS, consideration should be given to simplification of tax law and procedure concerning leverage leasing, participation by cooperatives as lessees, and facilitation of investment in leased equipment assets by individual investors.

These points are amplified in my prepared remarks.

Thank you.

The CHAIRMAN. Thank you. Mr. Oppenheimer.

TESTIMONY OF JERRY L. OPPENHEIMER ON BEHALF OF COMDISCO, INC.

Mr. OPPENHEIMER. Thank you, Mr. Chairman.

For the record, I'm Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, here in Washington, and I appear today as counsel to Comdisco, Inc., a New York stock exchange company and the world's largest remarketer of IBM computer equipment.

In summary, we are very concerned about the application of the administration's proposed accelerated cost recovery system to sales and leasebacks of short-life property, such as computers, to pre-1981 users.

This is the first problem noted a moment ago by Mr. Korn. Admittedly, it is a relatively narrow problem but an important one to taxpayers such as Comdisco.

Specifically, the administration would provide a significantly smaller deduction than that available under current law. Under its proposal, cost recovery for most tangible property involved in sale and leaseback transactions with pre-1981 users would be restricted to the equivalent of straight-line depreciation over 10 years.

Used computer equipment, as well as other kinds of used property, can now be depreciated over as few as 5 years under the ADR system using the 150-percent declining balance method, and many leasing companies use even shorter lives on a facts and circumstances basis.

Thus, the proposal would significantly penalize these transactions, and it's important to note that there are many significant nontax reasons for them.

For example, a lessee from IBM of a computer may exercise its option to purchase the equipment from IBM, apply its rental credits to reduce the purchase price of the equipment, and then simultaneously resell the equipment to and lease it from Comdisco.

In such a transaction, the user enjoys the benefit of rental credits, protects itself against technological obsolescence by leasing rather than purchasing for its own account, and may enhance its financial statements.

Similarly, companies such as Comdisco may make better use of available capital by selling equipment to investors and leasing it back to sublease to users. This is a preferred means for a leasing company to raise additional capital for new acquisitions.

Any leasing company involved in these transactions would be affected by the administration's proposal, but the burden will fall heaviest on those companies which specialize in short-life property.

In sum, their aggregate taxes may be substantially increased. Comdisco estimates that during the first 4 months of this year, the dollar value of its sale and leaseback transactions with pre-1981 users of computer equipment is about twice that of the corresponding period of last year. Nevertheless, for illustrative purposes, Comdisco has calculated that if its aggregate 1981 acquisitions, that is, all sales and leasebacks and other types of acquisitions in this year, were repeated using last year's figures, under the administration's proposals, its depreciation this year would be reduced by 32 per-

cent, by 30 percent next year, and by 10 percent in 1983. And it's important to note that this adverse treatment would not be offset by faster recovery on other assets or by an increase in its investment tax credits.

Because computers have short lives and because we are concerned only with used property, the severe adverse effects would last about 4 years.

Thus, we recommend with respect to sales and leasebacks to pre-1981 users, if the property currently has an ADR lower limit of 5 years or less, either the proposed accelerated 5-year cost recovery system should apply or a 4-year transition period should be available to allow the taxpayers to elect the same depreciation as permitted under current law.

The CHAIRMAN. Thank you.

I just asked the question I raised with Dr. James, I think in response to his answer—the Air Transport Association testified that leasing is an inefficient way of using tax benefits. I assume that you have a contrary view, at least you——

Mr. FINFER. I think he's wrong, Senator. Studies that we have ourselves indicate that leasing passes fully 100 percent of the tax benefits on to the lessee in the form of lower rentals, by present valuing the impact of those benefits and then adjusting the rentals downward.

So, we do not believe that the issue—the true issue—is one of passing through the tax benefits. We believe we are efficient in that regard.

The CHAIRMAN. How would you compare the lease transactions with refundable credits as efficient incentives to increase productivity?

Mr. FINFER. The refundable investment tax credit creates some serious problems for us in a philosophical sense and certainly as well as in a parochial sense.

Refundable investment tax credits are not discerning with regard to who gets the refund. If, for example, an airline decides, as one did last year, to carve out a new route structure and generates $35 million worth of losses for that quarter, then comes and says I cannot use my ITC because I'm buying planes, is it because they are buying planes? Well, is it because they are buying planes or because they are carrying a new route structure?

More importantly than that particular situation, happens to be the situation that the refundable ITC is not discerning with regard to all those other industries other than auto and steel that do have a serious problem that should be addressed in some other way.

What you're creating here is a general approach to corporations that are losing money. The approach is not discerning between those that are viable and those that are not viable. A check would be handed out just because they purchased equipment or say that they purchased equipment. The reason for the last comment is that we in the equipment leasing industry incur losses each year running into the hundreds of millions of dollars that are caused by frauds perpetrated on us by claims of delivered equipment. That's with audits, with checks, with verifications. I don't know how many of your IRS agents will be hired to screen requests for

refundable investment tax credit before the Government hands out those checks, but I venture to say that there will be none.

That creates a major fraud problem and how it's policed.

Mr. HEALEY. Can I comment for a second, Senator, on your question? I'm not speaking on behalf of anyone, but rather at the request of the staff, so I may have a slightly different point of view than the rest of the panel.

It's our experience that analysis of a lease is a fairly complicated process which is dependent on, among other things, two factors:

First, how long is it before the company currently not able to use the tax benefits might be able to use those benefits in the future? If it's a 1-year period before they can use the tax benefits that's substantially different than if they have investment tax credit which will carry forward a dozen years.

The second economic factor is the amount expected of the residual value of the equipment. One of the phenomena in the airline industry has been that the residual value of many of the current generation of aircraft has been substantially attractive. Because of the way that the tax rules of the Internal Revenue Service are structured the residual must go to the lessor. It is easy to imagine that a lessor may have a lower estimated value for the residual than the lessee and, therefore, that in analyzing a lease the lessor and lessee may come to different conclusions about whether or not it is attractive to lease.

[Senator Heinz and Grassley are here.]

The CHAIRMAN. Senator Long?

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Durenberger?

Senator DURENBERGER. Thank you, Mr. Chairman.

I would like to deal with the issue that we just left off on by reason of the chairman's question, and in particular, if that issue was brought into focus by both your answer and by a statement on page 3 of your written testimony in which you say:

> Equipment leasing is the most cost-effective method of financing for those companies that cannot fully utilize accelerated depreciation and investment tax credits on a current basis.

Leasing permits corporations to transfer tax benefits through the judgments of the marketplace without the added cost and inefficiencies resulting from direct Federal aid to corporations through subsidy measures such as refundable investment tax credit.

Having restated that as your position, I want to read to you some of the excerpts from someone else who writes in the Equipment Financing Journal, January–February 1981, George Brown, president of Babcock & Brown, an investment banking firm specializing in leverage leasing, and it goes on to describe his credentials a little further, and let me just put in perspective his position on what you have to say.

He talks about the Congress inability to see the problem, because it has trouble sometimes seeing the forest for the trees, or the Moon for the Earth and so forth, and he talks about our efforts in the past to stimulate investments and new plant machinery by legislating tax incentives such as accelerated depreciation and investment tax credit. He says that one of the problems that have been created by these incentives is that they just don't benefit

those who need them the most. Those who are not earning enough income to use the tax benefits and receive the tax rebate.

He then goes on to describe the nature of some of those industries. First, are those with normal income, but exceptionally large capital need, and I think we heard from some of those today. Second, are those in regulated industries which are prohibited from making sufficient income to utilize the tax benefits.

Third, are those in depressed industries, often depressed because they do not have the money to modernize their plants, and we heard from some of those.

And, finally, he gets to another issue I think that bothers a lot of us—the unincorporated associations and specifically cooperatives which produce no income because of their nonprofit structure, yet are no less deserving in this economy of ours with the benefit of tax incentives.

It then goes on to talk about the solutions and he describes your industry or the industry on whose behalf you speak, the leverage leasing industry, in the following terms:

> Some of the brightest and most creative minds in the modern world,

I assume they are here before us today,

> have been able to structure an unacceptable reality. A sale of tax benefits in terms of an accepted reality, a true lease.
>
> This structure called a leverage lease, basically allows an institution with a lot of taxable income to take the tax incentives of ownership and pass the benefit through to the lessee in the form of lower rental.

Then he goes on to talk about some of the problems involved here. Apparently, he is in the business, so he ought to know.

First, he says the transaction has become incredibly complex and he talks about the things you and I both know about and picks on lawyers. Hundreds of cross-reference, interdependence, single-spaced pages, representing the lawyers' version of wheels rotating on wheels.

Second, a tremendous amount of discussion is spent on issues that has a lot to do with the relevant form, which is leasing, but nothing to do with the reality of the transaction, which is the sale or benefit.

Third, because of the complexities and the irrelevancies, inordinate amounts of money are siphoned off by intermediaries such as lawyers, accountants, trustees, appraisers, printers, and of course, lease-brokers.

Fourth, the complexities and their relevancies also limit the market for buyers and sellers of tax incentives to relatively large and sophisticated institutions able and willing to undergo the pain, expense, and uncertainty of closing this kind of transaction.

Fifth, since the lease format has certain basic inconsistencies with the reality of the sale of tax benefits, completely free sale of tax benefits is prevented. He then goes on to give some examples. Then he deals with the solution which is in effect a relatively simple sale which could be handled through a one page document which stated the purchasing party could use the tax benefits to the same extent the selling party would have been able to use them had it any income.

So, my basic question of you is: What in your opinion other than what you have described before, are the added costs of the RITC;

what are the inefficiencies resulting from the RITC; and then what are the costs of using leverage leasing, the cost of lawyers and accountants, printers, trustees, and appraisers and everybody else; and what are the inefficiencies in hundreds of hours of lawyers and printers and so forth? Aren't we being here asked to, in effect, save an industry that has been created by the brightest and the most creative minds in the modern world because of our lack of foresight.

Mr. FINFER. Wow! If you don't mind I would like to answer the question in the reverse and start off with the equipment leasing industry and what I think accounts for any inefficiency in the industry.

I covered essentially, in a broad stroke way in my oral comments, and Barry Korn made reference to it in his oral comments, the Internal Revenue procedures as they relate to leasing.

In 1975 the IRS became very much concerned with the leasing industry as it began to really grow, and so it came out with Revenue Procedure 75-21 and 28 which essentially circumscribed existing business practices at that point and time.

Unfortunately, because it did that and maintained the status quo in terms of where the industry was at in terms of sophistication, no one really screemed and yelled too vociferously because 75-21 and 28 were based upon a basic misconception, and that basic misconception was that investment tax credit and depreciation have zero economic value, something we all know to be untrue, because we're fighting about it here today.

Since, 1975 IRS has promised that they will continue to review—they will review 75-21 with a view toward making our industry more efficient. Each year it gets put on a back burner.

If that were addressed today under current tax law as efficient as we are, we could be more efficient. It is the artificial rules created by Internal Revenue Service that cut down the efficiency.

Lawyer costs, yes. Mr. Brown's fees as a broker, yes. That does add to the cost. But those costs would not be there to the extent that they are, were IRS to come to 1981 with regard to the sophistication of the industry and allow it to become a more efficient mechanism for transferring the tax benefits.

As I go on to the next issue, which is the inefficiencies of refundable investment tax credit, I guess my major concerns are these:

If one of those hurting industries were to go out tomorrow with refundable investment tax credit and buy a $20 million executive aircraft all specked out with gold handles on the wash basins, they would still be entitled to a refundable investment tax credit.

Senator DURENBERGER. As they would to an investment tax credit.

Mr. FINFER. Exactly. There are industries that have to be helped, and I think that is the overriding concern here.

I think that they should be helped, but I think that they should be helped with controls on where they direct their funds, the same way New York City was helped, the same way Lockheed was helped, and the same way Chrysler was helped.

I don't think it ought to be approached in terms of refundable investment tax credit, which not only applies to these industries

that are hurting, but applies to anyone who cannot continue to be a viable economic entity today.

Mr. KORN. Senator, if I might add—I would like to emphasize the self-policing point that companies have to justify on a financial basis the acquisition of additional equipment and to use the example of a corporate jet which may be viewed as a luxury by some and as a necessity by others.

If that corporation is earning profits and paying its share of taxes, and can afford that and feels that it is more efficient to do that, that's fine. It is a lot different if you have an inefficiently, poorly managed company that has not been able to keep pace with its competitors, who is getting a refund of cash with which it can take those funds and do things which really don't benefit the capital formation problem that you are addressing.

Mr. FINFER. Senator, when the banks and the insurance companies and the pension funds cut Chrysler off from credit and the Federal Government was deciding what to do, it was the equipment leasing industry that was still providing Chrysler with tens of millions of dollars worth of machine tools.

We were taking the risk. We made an independent free market assessment of the continued viability of Chrysler. We decided that they did have a viable future and we made those judgments. There would be no such judgments under refundable investment tax credit.

If, as Congressman Rostenkowski suggests, there would be something like an extension of the net operating loss carryback, that would be more acceptable to us as an industry, again philosophically, because you would be talking about taxes that were already paid by these industries as opposed to taxes which they have not paid.

It would seem to me that it is hard justifying Congress passing the budget resolution, which as mentioned before, cut down on medicaid, cut down on welfare, only to give back money, as automatically refundable to them, because their net operating loss carryforwards have already been exhausted, to take money from those areas and give them to corporations many of whom are not financially viable and would not be buying the equipment were it not for the dollars they will get back from the Government is inconsistent.

Senator DURENBERGER. Well, I just have a hard time with the theory that, you know, we ought to follow the Lockheed or the Chrysler course, when you are in here arguing for the marketplace to work better. We ought to have tax reform to make sure that happens, and with regard to the argument, you know, somebody who is already going downhill is going to take taxpayers' money down with them. I mean we are talking about 10 percent of a 100-percent investment, and it sounds to me as though you have yourself or your industry out there trying to protect the public interest from the marketplace at work.

We are not financing 100 percent of that goldplated jet aircraft or whatever it is, we may at best be financing 10 percent or something slightly less than that.

I guess the argument was made here this morning, that putting aside our lousy energy policies, or whatever in this country, that a

refundable investment tax credit might have saved Chrysler and might still save a Ford Motor Co.

It isn't going to do anything for General Motors because they are already subsidized to the tune of every 10 percent of all of their capital investment.

So, I appreciate your reactions. Now that I'm chairman, I'm going to make part of the hearing record on refundability, in other words, the advocates thereof, which is the previous panel, the article by George Brown entitled "Leverage Leasing, Is It Really Necessary," and I would like to thank all four of you for your presentation.

Senator DURENBERGER. Senator Symms, do you have a question of this panel?

Senator SYMMS. Thank you, Mr. Chairman. I'll just be very brief.

In a lease financing situation where the free market is allocating the credit to purchase diversed capital assets, but in that industry independent parties make a judgment as to the creditworthiness of the lessee, isn't the fundamental flaw in the refundable portion of this that it replaces the market judgment or—that's your point.

Mr. FINFER. Yes, sir. Mr. Korn. In addition to the judgment, it leads to potential abuse, that is you have the potential which was alluded to earlier of corporations claiming that they acquired assets for their own account and then taking the refunded investment tax credit and those corporations won't be around a few years later when the IRS auditors show up at their door to find out if in fact they have it.

I respectfully submit, that it is a tremendous problem to be able to—from a mechanical point of view in terms of the refundability issue. I would like then to reemphasize the point that Paul Finfer made earlier with respect to the IRS procedure 75, 21, and 28 that by eliminating those revenue procedures you will make leasing much more efficient and be able to offer more transferability of the investment tax credit to the lessee users of the equipment and still retain the self-policing mechanisms without having any additional abuses.

[The statements of the preceding panel follow:]

STATEMENT

OF

PAUL M. FINFER

ON BEHALF OF

THE AMERICAN ASSOCIATION OF EQUIPMENT LESSORS

BEFORE THE

SENATE FINANCE COMMITTEE

May 19, 1981

We in the American Association of Equipment Lessors (AAEL) thank the Committee for allowing us to testify in support of the business tax-cut proposals in S. 683. AAEL is the major trade association in the multi-billion dollar equipment leasing industry, which accounts for nearly twenty percent (20%) of all capital investment made each year in the United States. Our industry is growing very rapidly, from $20 billion worth of capital equipment purchases in 1975 to nearly $40 billion worth of capital equipment purchases in 1980 by equipment lessors. Over $150 billion of gross lease receivables is now outstanding. Today, AAEL represents the largest single group of capital equipment investors in the United States.

Our AAEL members are engaged in the leasing of all types of productive equipment, from the office typewriter to utility generating facilities costing hundreds of millions of dollars. Equipment leasing covers all manufacturing and service industries. AAEL members lease machine tools, computers, communication equipment of all kinds, utility plants and equipment, fertilizer plants and farm equipment, commercial and corporate aircraft, coal mining equipment, oil drilling equipment and all other types of personal property. AAEL's annual surveys indicate that out of the $40 billion worth of capital assets

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purchased by equipment lessors in 1980, approximately $6.6 billion (or 16.3%) was spent for production equipment (such as machine tools). These figures have been increasing each year, since <u>the equipment leasing industry has been expanding rapidly</u> as more and more businesses turn to leasing (rather than other financing alternatives) as a cost effective and efficient way to acquire needed capital equipment. While short term operating leases of these assets are growing very rapidly, the overwhelming amount of capital equipment is leased to one user (a lessee) for 80% of its useful life.

The membership of AAEL consists of over 700 corporations, ranging from large and small banks or bank subsidiaries (over 200), independently owned lessors, insurance companies, major finance companies, and finance subsidiaries of manufacturing companies, to investment bankers and lease brokers. These members collectively engage in all aspects of equipment leasing affecting virtually every industry in the United States. The membership of AAEL is not involved in, nor is AAEL interested in defending, any abusive "tax shelter" arrangements. What the AAEL represents is the mainstream of the equipment leasing industry, which engages in legitimate leasing transactions every day, accounting for approximately

twenty percent (20%) of all capital formation each year in the United States.

Tax-cut Legislation: S. 683

AAEL completely supports the purposes of President Reagan's business tax-cut proposals in S. 683. Enactment of legislation providing for accelerated depreciation would have a very favorable impact on capital spending, capital formation and the productivity improvements required if the United States is to retain its place as a world economic leader. We think that business tax-cut legislation of this type is crucial to the revitalization of American industry.

At the same time, we believe that Congress should insure that the new tax benefits are utilized properly and efficiently. Equipment leasing is the most cost effective method of financing for those companies that cannot fully utilize accelerated depreciation and investment tax credits on a current basis. Leasing permits corporations to transfer tax benefits through the judgments of the marketplace, without the added costs and inefficiencies resulting from direct federal aid to corporations through subsidy measures such as "refundable" investment tax credits. Today the equipment leasing industry is extremely competitive. In most major leasing transactions

involving the acquisition of productive capital assets, virtually all of the tax benefits of ownership are passed on to the lessee in the form of lower rental prices. In this way, lessees (equipment users) receive the tax benefits intended by Congress to stimulate capital investment. This type of economic efficiency is important to the nation, because the equipment leasing industry accounts for approximately 20% of all capital equipment acquisitions each year.

To allow the equipment leasing industry to continue to operate as an efficient economic mechanism for capital formation, the AAEL seeks some technical amendments to the current tax-cut bill. We have four major concerns.

1. Technical IRS Revenue Procedures

One of our principle concerns is with the artificial restraints on economic efficiency, and on competition, that stem from two technical Internal Revenue Service tests. These two tests (together with other requirements) define when "true lease" tax status will be accorded to major "leveraged lease" transactions (which account for most of the dollar volume in the leasing industry). President Reagan's intended increase in tax benefits through accelerated depreciation would not fully accrue to the benefit of lessees (equipment

users) unless Congress requires some adjustment in these two technical IRS tests -- called the "profit" and "cash flow" tests of IRS Revenue Procedure 75-21 and certain follow-up Revenue Procedures. Were S. 683 simply enacted as proposed, an owner-lessor in a leveraged lease transaction would have to increase his equity investment. Moreover, he could reduce his lease rates only modestly or he would violate the technical "profit" and "cash flow" tests, which under the existing IRS Revenue Procedures must be met without taking into account any tax benefits.*/ This violation of the tests would invite the IRS to rule that an otherwise valid lease was not a "true lease" and, consequently, to disallow all the tax benefits of the lease. The two IRS tests would thus restrain competition in major leveraged lease transactions by placing an artificial floor under pricing through which lessors could not descend, even though the marketplace (after enactment of the tax-cut legislation) would accommodate lower pricing to the lessee.

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*/ The core "profit requirement" test of IRS Rev. Proc. 75-21 Section 4(6) and IRS Rev. Proc. 75-28 Section 4.07(1) requires that the owner-lessor achieve a profit, exclusive of tax benefits, from the transaction. The "cash flow" test of IRS Rev. Proc. 75-28 Section 4.07(2) requires that the lease payments collected by the owner-lessor must exceed his disbursements (exclusive of initial equity investment) by "a reasonable minimum amount."

There is no sound economic, legal or policy justification for this result. Lease rates could be reduced substantially, in the wake of the tax-cut legislation, if these two technical tests in Rev. Proc. 75-21 and Rev. Proc. 75-28 were modified to remove some of their artificial restraints.

Tax-cut legislation like S. 683 shows that Congress and the Administration already recognize the economic value that accelerated capital cost recovery and investment tax credits have as an inducement to investment in capital equipment. Accordingly, we believe that Congress should also recognize that, in determining whether a transaction is a sale or a lease for tax purposes, a corporation may consider these same tax benefits as part of the economic substance of the transaction. This Congressional action would not affect any other part of the tax laws, apart from the two specific technical tests known as the "profit requirement" and "cash flow" tests of IRS Rev. Proc. 75-21 Section 4(6) and IRS Rev. Proc. 75-28 Section 4.07. Nor are we attempting to define a lease. The Congressional action we urge, however, would allow a continuation of effective lease pricing for the increasing number of American companies who select leasing as a means of acquiring the use of capital equipment.

One possibility for appropriate language to be added to the tax-cut legislation would be the following:

[New Section 168(h)(8) on page 47 of S. 683]

> "(8) Leasing.-- In determining whether a transaction is a sale or a lease for tax purposes, a corporation other than a personal holding company under Section 542 of the Code may consider the tax benefits of ownership as part of the economic substance of the transaction."

This or comparable language might be explained in the legislative history in the following or similar terms:

> "With respect to the tax treatment of equipment leasing by corporate lessors, S. 683 would modify the 'profit requirement' and 'cash flow' tests of IRS Rev. Proc. 75-21 Section 4(6) and IRS Rev. Proc. 75-28 Section 4.07 so that the corporate lessor's 'profit' and incoming 'cash flow' shall include the value of the lessor's tax benefits arising from the lease transaction. This modification of IRS rules is necessary to ensure that the tax benefits of the legislation are most effectively utilized by the American business community."

This suggestion by AAEL would not do violence to the judicial case law. The only basis in the court cases for the two technical IRS tests seems to be the judicially created legal principle that, to have tax effect, a transaction must demonstrate a business purpose, economic substance, and/or purposive activity. See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967); Herbert D. Weiner, 58 T.C. 81 (1972), affirmed per curiam, 494 F.2d 691

(9th Cir. 1974); Arnold L. Ginsberg, T.C.M. 1976-199. Yet the economic substance of equipment leasing transactions is plain in the owner-lessor's substantial equity investment in the capital asset, the owner-lessor's risk that lease payments will not continue to flow in if the lessee defaults, and the owner-lessor's chance for substantial profit (or loss) depending on how market forces affect the resale value of the capital asset at the end of the lease term. Cf. Frank Lyon Co. v. United States, 435 U.S. 561 (1978). We submit that the court-created tests for "economic substance" do not support the IRS Revenue Procedures' "disregard of tax incidents enacted by Congress with the specific intent of encouraging investment when such investment might otherwise not be made -- i.e., of making presumably unprofitable investment attractive." Equipment Leasing--Leveraged Leasing pp. 450-451, by Fritsch & Reisman (PLI, 2d ed. 1980). The tax laws on investment credit and accelerated depreciation were enacted for the purpose of encouraging capital investment. Yet the IRS Revenue Procedures' "profit requirement" and "cash flow" tests require that even these economic benefits be totally disregarded and not counted as part of the owner-lessor's "profit" or in-coming "cash flow."

At a minimum, AAEL requests Congress to recognize that, in determining whether a transaction is a sale or a lease for tax purposes, a corporation may consider the additional (or incremental) tax benefits of ownership, newly provided by S. 683, as part of the economic substance of the transaction:

[New Section 168(h)(8) on page 47 of S. 683]

> "(8) Leasing.-- In determining whether a transaction is a sale or a lease for tax purposes, a corporation other than a personal holding company under Section 542 of the Code may consider the additional tax benefits of ownership newly provided by this statute as part of the economic substance of the transaction."

This Congressional action would basically amount to a "safe harbor" provision, protecting under the President's new tax law those lease transactions with sufficient economic substance to pass muster under current tax laws and regulations, while allowing corporate lessors to pass on to lessees (in the form of lower lease rates) the full economic benefit of the President's new tax cuts.

The overriding purpose of President Reagan's increased business tax-cuts is specifically to encourage American businessmen to make new investments in plant and machinery that otherwise might not be made. There can be no mistake about this point or the President's purpose. Our AAEL view

is that, in light of this purpose, owner-lessors should at the very least be permitted to consider the additional (incremental) tax benefits of ownership, newly provided by S. 683, as part of the economic substance of lease transactions.

2. Flexibility in Taking ACRS

AAEL also urges this Committee and the Congress to provide taxpayers with an option, and the flexibility, to take less than the maximum depreciation deduction provided for under the Accelerated Cost Recovery System ("ACRS") of S. 683. The current version of S. 683 mandates that cost recovery must be deducted in the year in which it is allowable. Even if no depreciation deduction is claimed in a particular year, the basis of a depreciable asset must be reduced by the maximum depreciation allowable under ACRS. To the extent the depreciation deductions are not used in a particular year, they are taken into account under ACRS as a net operating loss (NOL). Such losses may be carried back three years or carried forward 10 years under ACRS.

This mandatory system should be amended, we submit, to give taxpayers the option of taking either (1) the maximum cost recovery deduction provided for under ACRS, or (2) straight-line depreciation for a capital asset, using the ACRS system

for determining an asset's useful life as 10-, 5-, or 3-year property. The tax basis of a depreciable asset should be reduced in accordance with current tax law principles, with basis reduced according to which option the taxpayer actually chooses for taking depreciation. These modifications would keep the new cost recovery system relatively simple and would not create administrative problems, while giving business taxpayers some much-needed flexibility in taking cost recovery deductions.

We urge Congress to provide this flexibility for several reasons. The option of recovering capital costs over a longer period of time allows each business some flexibility to recover its capital investment at the particular rate which is most advantageous to it. The option will maximize the incentives to invest by preventing the possible loss of recovery deductions by some taxpayers. Moreover, overloading a corporate taxpayer with unneeded recovery deductions that it cannot use may actually harm corporate balance sheet statements made available to corporate stockholders and the investing public. Where the overload of unneeded recovery deductions and NOLs becomes large enough, so that a corporate taxpayer cannot be reasonably certain that it will generate

taxable net income against which to take unexpired investment tax credits, then accounting principles may not allow the corporation's balance sheet to reflect such investment credits. This would make the corporation's balance sheet (specifically, its reportable earnings and financing costs) look worse to prospective investors and may adversely affect the corporation's decision to invest in capital assets.

For all these reasons, AAEL joins with many others in urging Congress to provide some flexibility in the cost recovery deduction schedules of S. 683.

3. Foreign Assets

Under present tax law, assets used predominately outside the United States may be assigned guideline lives under the Class Life ADR system, but the 20 percent variation is not applicable. See Treasury Reg. §1.167(a)-11(b)(4). Accelerated depreciation is generally permitted for such foreign assets over the applicable lives. However, S. 683 would greatly extend the recovery periods for assets used predominately outside the United States, and it would require the straight-line method of depreciation over these extended periods. The modified recovery periods for foreign personal property would be 20 years for 10-year personal property, 10 years for 5-year property, and 5 years for 3-year property.

Our Association seeks modification of these provisions of S. 683 which would deny accelerated depreciation to foreign assets and which provide that such property would be depreciated only over greatly extended, modified recovery periods. These provisions may limit the ability of U.S. companies to compete effectively in foreign countries, and may not promote the purchase of property from U.S. manufacturers for use abroad. AAEL recommends that S. 683 should be amended to provide that investments in foreign personal property may be recovered by using the same 10-, 5-, and 3-year recovery periods that would apply to assets used in the United States. AAEL does not object to the use of the straight-line recovery method over these recovery periods.

4. Sale and Leaseback

AAEL is also concerned with the potential adverse impact on some segments of the equipment leasing industry of proposed Code §168(f)(5)(A) [p. 37 of S. 683]. This specific provision in the tax bill would restrict cost recovery deductions for tangible property used before January 1, 1981 and involved in sale and leaseback transactions, limiting deductions to the equivalent of straight-line depreciation over ten years. We are informed that this provision is

intended to prevent potential abuse of the accelerated cost recovery provisions of S. 683.

The problem we see is that proposed §168(f)(5)(A) may unfairly penalize particular segments of the leasing industry concerned with relatively short-lived capital assets, in which sale and leaseback transactions are a frequent business practice, entered into for well-established business reasons unrelated to any potential tax abuse. The classic case is the computer leasing industry. The Committee should give serious consideration to adopting a transitional rule preserving for a few years the existing depreciation rules for property involved in sale and leaseback transactions. This sort of transitional rule, we believe, would prevent potential abuses without the serious adverse impact that proposed §168(f)(5)(A) would have on the computer leasing industry.

Conclusion

We support the Economic Recovery Tax Act of 1981 and the President's business tax-cut proposals as the best approach for encouraging increased capital formation and productivity in America. Today the equipment leasing industry accounts for twenty percent (20%) of all capital investment

each year in the United States. The Congress should modify some technical aspects of the tax-cut legislation, AAEL submits, in order to permit equipment leasing to continue to fulfill its vital role as a beneficial, efficient, and cost effective way of financing the use of capital assets.

ADDENDUM TO STATEMENT AND SUMMARY OF STATEMENT OF PAUL M. FINFER

Paul M. Finfer is a member of the Board of Directors and Chairman of the Federal Tax Subcommittee of the American Association of Equipment Lessors (AAEL), on whose behalf his appearance, and this Statement, are made. Mr. Finfer is President of Beneficial Leasing Group Inc., New York City, a subsidiary of Beneficial Corporation, of Morristown, New Jersey.

Computer Dealers and Lessors Association, Inc.
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Office of Executive Director

STATEMENT OF

BARRY P. KORN

BEFORE THE

SENATE COMMITTEE ON FINANCE

SUMMARY

1. Sale and Leaseback Transactions

The proposal to exclude sale and leaseback transactions from the benefits of the accelerated cost recovery deduction provided for in the Bill particularly hurts lessors of short-lived assets, such as computers.

We recommend that this provision be deleted and replaced with language which calls for a five-year transition period, after which time the standard capital cost recovery provisions of the Bill will be utilized. During the interim five year transition period, we recommend the continuation of the existing ADR system.

2. Flexible Depreciation

Mandatory use of five-year accelerated depreciation for most equipment will produce a financial hardship on small and medium-sized leasing companies, and particularly on computer lessors.

Language such as that provided on Conable/Jones H.R. 1053, which provides that a taxpayer may deduct less than the full capital cost allowable and carry forward any amount allowable for the taxable year but not deducted, should be included in the Bill.

3. Elimination of 75-21 and 75-28 for Corporate Lessors

The intended increase in tax benefits resulting from the accelerated depreciation provided by the Bill will not fully accrue to the lessee's benefit unless Congress requires adjustment to Internal Revenue Service Revenue Procedures 75-21 and 75-28.

The Bill should provide language to eliminate the requirements of Revenue Procedures 75-21 and 75-28 with respect to equipment leasing transactions by corporate lessors.

4. U.S. Owned Property in Foreign Countries

The proposed Bill places U.S. lessors in a weakened position relative to foreign lessors due to the reduced allowance for depreciating owned assets which are located in other countries.

We recommend the elimination of those provisions from the Bill which provide that such property be depreciated over 6 or 10 years rather than 3 or 5 years.

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Office of Executive Director

Good morning, I am Barry Korn, President of Barrett Capital & Leasing Corporation. Thank you for the opportunity to express the views of our industry trade group, the Computer Dealers and Lessors Association (CDLA).

CDLA's predecessor, the Computer Lessors Association, was organized in 1967 to promote the business of marketing or managing computer equipment for lease or sale. CDLA's membership consists of 150 small, medium and large companies. The Association estimates that, since its inception, its members have purchased almost $10 billion worth of computer systems for lease to end users. CDLA also estimates the annual used computer market at $1 billion in 1980.

Our industry has demonstrated the economic benefits of used computers and of third party computer leasing. To date, we estimate end user savings totaling $1.5 to $2.0 billion. CDLA applauds the Administration's and Congress' desire to encourage economic growth through accelerated capital cost recovery of investment in plant and equipment.

In reviewing S.683, however, it has come to our attention that the computer leasing industry will be penalized unless certain changes to the Bill are made. Our concerns and recommendations are:

1. Sale and Leaseback Transactions

Proposed Code Section 168 (f) (5) (A) (page 37, line 6 of S.683) excludes from the benefits of the accelerated cost recovery deduction provided for in the Bill certain property used prior to January 1, 1981 that, after being acquired from the user, is leased back to him -- that is, sale and leaseback transactions. This exclusion particularly hurts short-lived assets, such as computers. The proposed Bill would restrict recovery to straight line depreciation over ten years, compared to the current Class Life Asset Depreciation Range (ADR) system, which permits 150% declining balance depreciation over five years.

It is important to note that it is common practice in the computer industry for manufacturers to provide "rental credits" to customers to induce them to purchase their computers after a period of time. Often, such companies either are not in a position to purchase the equipment or choose not to tie up their capital in this manner. The third party computer lessor enables the user to enjoy the benefit of the rental credits through cash savings generated by a lease resulting from the lessee's purchase, at a reduced cost, and sale to the lessor of the equipment.

These transactions contribute to improving capital formation, increasing productivity and business growth and pass the technological risk to the lessor. However, a ten year period is too long to depreciate computer equipment. We understand that the concern of the Administration is the potential abuse of "churning" assets; that is the use of sale and leaseback transactions to depreciate existing longer-lived assets over a five year period. We further understand that this concern is of a transitory nature and will eliminate itself over time.

Accordingly, we recommend that Section 168 (f) (5) (A) be deleted and replaced with language which calls for a five year transition period, after which time the standard capital cost recovery provisions of the Bill will be utilized for sale and leaseback transactions. During the interim five year transition period, we recommend the continuation of the existing ADR system, which, with respect to computer leasing properly reflects current conditions and would not adversely impact our industry.

2. Flexible Depreciation

Proposed Code Section 168 (b) (page 23, line 16 of S.683) provides for the mandatory use of 5 year accelerated depreciation for most equipment compared to existing law, which allows a flexible period and method over which to depreciate property. This forced acceleration will produce a financial

hardship on small and medium sized leasing companies, and particularly computer lessors.

Small to medium sized companies that develop a growth plan consider the retention of earnings a critical element in capital formation and in building a base of equipment held for lease. The utilization of the investment tax credit by these firms, therefore, is most important. Being forced to depreciate equipment more rapidly than economic conditions would otherwise dictate creates excessive depreciation, which in turn, leads to reduced earnings and the inability to utilize investment tax credits on a timely basis. Given a strategic plan of high growth, the investment tax credits may never be utilized and the growth of the company is stunted.

This problem is further compounded in the computer leasing industry. The use of a depreciable life for tax purposes shorter than that used for financial reporting purposes has often created confusion in the minds of lending institutions and stockholders. It is incorrectly perceived that the resulting financial statements are overstated. To maintain capital formation in the computer industry, it is important for our financial institutions to understand that our financial statements reflect realistic expectations. It is interesting to note that this opinion also has been expressed by one of this country's largest computer companies,

suggesting that this is a concern of both large and small lessors and manufacturers.

Therefore, we recommend that S.683 adopt language such as that provided in Conable/Jones H.R. 1053 (page 6, line 11), which provides that a taxpayer may deduct less than the full capital cost allowable and carry forward any amount allowable for the taxable year but not deducted.

3. Elimination of 75-21 and 75-28 for Corporate Lessors

It has been demonstrated that equipment leasing has been a potent force for capital formation. For example, the American Association of Equipment Lessors estimates that 20% of capital equipment is now acquired through leasing. However, the intended increase in tax benefits resulting from the accelerated depreciation provided by the Bill will not fully accrue to the lessee's benefit unless Congress requires adjustment in Internal Revenue Service procedures issued in 1975 -- Revenue Procedures 75-21 and 75-28. Such an adjustment also would clarify other requirements of these Revenue Procedures like the Minimum Investment, which are not supported by case law and which serve to discriminate against small equipment lessors and asset managers. We believe that Revenue Procedures 75-21 and 75-28 are not in line with current market conditions and impede capital formation in this country, particularly in view of a finite equity and tax base.

We recommend that the Bill provide language to eliminate the requirements of Revenue Procedures 75-21 and 75-28 with respect to equipment leasing transactions by corporate lessors.

4. U.S. Owned Property in Foreign Countries

Section 168 (h) (2) (page 44, line 17) and Section 207 (a) page 74, line (13) provide for a 10-year straight line depreciable life for assets owned by U.S. equipment lessors, but which are located in other countries. In our opinion, this provision places U.S. lessors at a competitive disadvantage relative to foreign lessors. In view of increasing "cross border" leasing, that is, assets owned by a lessor in one country leased to a lessee in another country, and a "world economy" we don't believe that it is the intention of the Administration or Congress to place U.S. lessors in a weakened position. This is a particularly sensitive issue to computer lessors, due to the shorter life of computers relative to the proposed 10-year recovery period.

We recommend, therefore, the elimination of those provisions from the Bill which provide that such property be depreciated over 6 or 10 years rather than 3 or 5 years. If it is necessary to differentiate between assets located in the U.S. and assets located abroad, we recommend the use of straight line depreciation instead of accelerated depreciation over the same recovery period as provided for U.S. assets.

CDLA understands the complexity of the issues you face in S. 683 and the intense time pressures you are under. We have attempted to keep our proposals in line with the expressed purposes and simplicity of the Bill. We respectfully request your favorable support of our recommendations, and, would welcome the opportunity to work with the Committee and its staff on technical language to implement our suggestions.

Thank you. If there are any questions, I would be pleased to try to answer them.

PROJECT FINANCE GROUP

ACCELERATED COST RECOVERY SYSTEM

Testimony Before The

Committee on Finance

United States Senate

by

Thomas J. Healey
Managing Director - Investment Banking
Dean Witter Reynolds Inc.

May 19, 1981

INTRODUCTION

Good morning. I am honored to have been invited to address the United States Senate Committee on Finance on the subject of the proposed Accelerated Cost Recovery System ("ACRS"). I am not here as the representative of any organization or interest group, but, presumably, because of my experience in arranging large tax-oriented lease transactions for a wide variety of companies. My remarks will cover three areas:

- What is leasing and what are its benefits?
- What would be the economic impact of ACRS on real estate and equipment leases?
- What are some of the special implications for the electric utility industry?

I am Managing Director-Investment Banking of Dean Witter Reynolds Inc. in New York City and have headed that firm's Project Finance Group for the past three years. During that period we have acted as agent or advisor on more than 20 equipment and real estate financings representing in excess of $2.5 billion in assets. The vast majority of these financings has been in connection with energy projects, frequently involving electric utilities as either project sponsor or customer. I have authored or co-authored a number of papers on related subjects which have been published in Public Utilities Fortnightly, Electric Light and Power, Novick's Income Finance Report and Business, among others. I am also a frequent speaker on leasing and energy financing. Prior to joining Dean Witter Reynolds six years ago, I was a financial officer in the electronics industry. I am a Chartered

Financial Analyst, received my bachelor's degree from Georgetown University and an M.B.A. in computer science and finance from Harvard. Clearly, however, the most constructive three months of my training were those spent in 1962 as an intern in the U.S. Senate with Senator Homer Capehart of Indiana. I am pleased to have been asked back, even though it has taken 19 years!

WHAT IS LEASING AND WHAT ARE ITS BENEFITS?

Leasing is a method through which a company can finance the long-term use of plant, real estate or equipment. Except where specifically mentioned, I will not distinguish between leases of real and personal property, although they differ in notable aspects. Furthermore, I will generally refer to leveraged leases, the typical form for larger lease transactions. In a leveraged lease, assets which have been ordered by the company are purchased by a group of equity investors (collectively, the "Lessor") and in turn rented (or leased back) to the company on a net basis ("net" meaning that the lessee is responsible for maintenance, insurance, etc.) for a substantial portion of the equipment's economic life. Leveraged lease financing has become a major source of funds in recent years. While I know of no reliable statistics on the total amount of assets leased, I am aware that one Lessor alone invested in over $1 billion of leased assets in 1980.

The Lessor finances a large portion (from 60% to 100%) of its investment in the asset through the issuance of long-term secured debt. This debt is non-recourse to the Lessor; the lenders look

solely to proceeds from rental payments and the underlying collateral value of the asset for credit support. The Lessor, as owner of the asset for tax purposes, is able to realize the benefits of investment tax credit and deductions for depreciation and interest expense. A diagram of a typical leveraged lease appears on the next page. You will quickly perceive from the diagram that a leveraged lease can be a complicated transaction.

These tax benefits, together with a nominal cash return and the residual value of the asset which accrues to the Lessor at the expiration of the lease, allow the Lessor to recoup its initial cash investment along with a suitable return on that investment. Because tax benefits, and depreciation in particular, are so important to lease economics, ACRS could have a significant impact upon the economics of leveraged leasing, as will be demonstrated below.

The principal advantage of leveraged leasing to a company is the possibility of substantially reducing the cash financing costs of an asset by transferring the tax benefits of ownership to the Lessor. This method of financing is most advantageous to the company when it is unable to utilize such tax benefits itself on a timely basis because of insufficient taxable income against which such credits or deductions may be offset. A Lessor with significant taxable income can use lease-generated tax benefits as an offset to such taxable income and can consequently accept a modest cash yield on an investment in a leased asset while still achieving a very favorable total return. The end result is that the company, as lessee, is able to

LEVERAGED LEASE

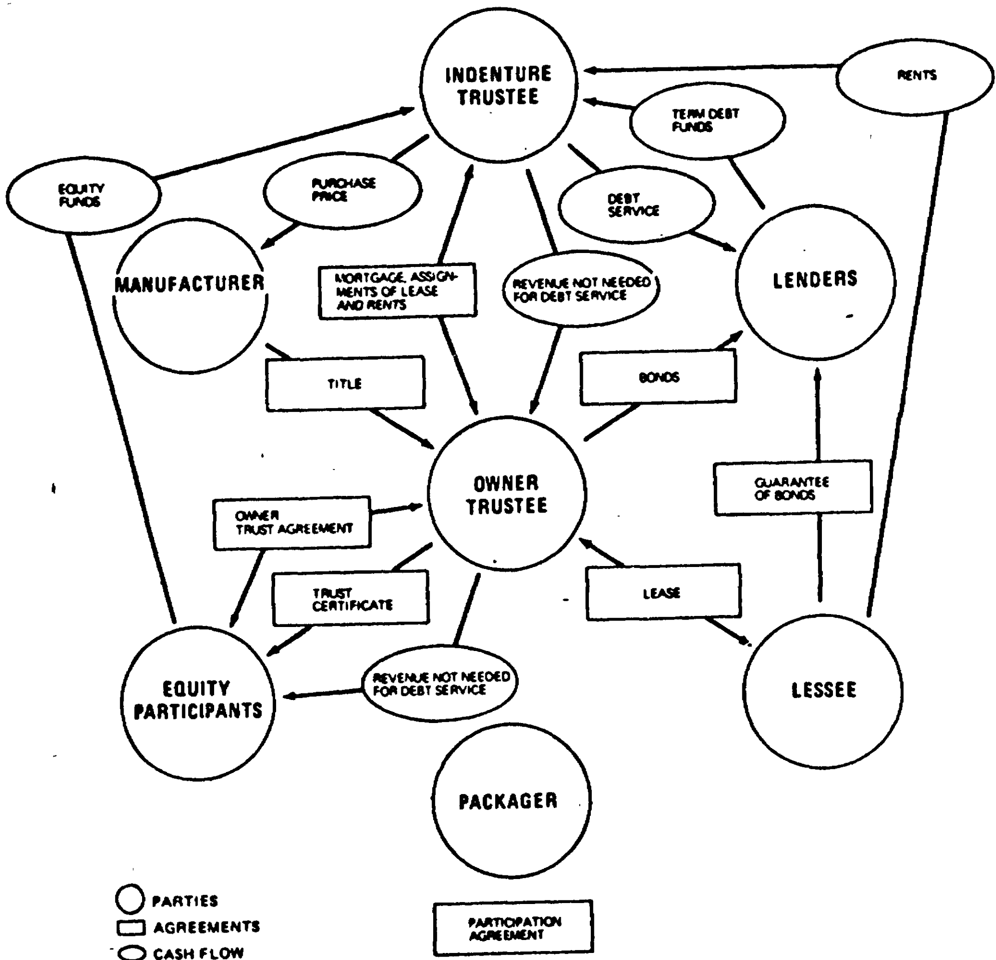

Figure 1

Source: Nevitt, Peter. Project Financing
AMR International, Inc., 1975

enjoy indirectly, in the form of lower rentals, tax benefits which would otherwise be lost or not utilized on a timely basis if it owned the asset outright. A lease therefore transfers tax benefits from an ineffective user to an effective user, while providing the former with a lower financing cost.

Tables 1-6 illustrate the advantage of leasing to a company which is unable to utilize the tax benefits of ownership on a current basis. Example I (Tables 1-3) compares the net cash flow effect of leasing with that of owning for a company with a marginal tax rate of 0%. As can be seen from Table 3, the net present value advantage of leasing for the non-taxpaying company is over $250,000 for each $1 million in original asset cost. Conversely, Example II (Tables 4-6) demonstrates that leasing has a net present value disadvantage compared to ownership for the company which expects to be able to utilize the tax benefits of ownership on a current basis. Example II, which uses the same assumptions as Example I except that the company is assumed to have a marginal tax rate of 50%, shows a net present value advantage of owning the asset of approximately $65,000 per $1 million in original asset cost. While these two examples are certainly simplified cases, they do serve to emphasize the tax-oriented nature of leasing: that is, the advantages of leasing compared to owning depend to a very great degree on the company's expected ability to generate future taxable income.[1]

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[1] Note that these examples ignore the residual value of the asset, which always goes to the owner, i.e. the company in the "own" case and the Lessor in the "lease" case.

WHAT WOULD BE THE IMPACT OF ACRS ON REAL ESTATE AND EQUIPMENT LEASES?

The proposed new depreciation plan will provide for faster write-off of capital expenditures. It would provide a standard schedule of deductions using the 10-5-3 concept for machinery and owner-occupied manufacturing structures, and prescribes depreciation lives for two classes of real estate. As proposed, ACRS would be applicable to capital investments in new and used property made after December 31, 1980. However, the accelerated recovery period for capital investment would be phased in over the next five years, so that the full effect of ACRS would not be felt until 1985.

Effect of ACRS on Real Estate Leases

Dean Witter Reynolds has undertaken a detailed analysis of the impact of the proposed tax changes on real estate net lease transactions. We have looked at their potential impact in 1981, the first year of the phase-in period, and in 1985, when the changes would be fully in effect. The sensitivity of the economics of real estate net lease transactions to alternative tax change scenarios has also been analyzed. Dean Witter Reynolds' analysis indicates that under most of the scenarios projected:

1. Real estate net leases of new property will likely become uneconomic for full taxpaying companies.

2. Real estate leasing will remain attractive for companies unable to utilize tax benefits in a timely and efficient manner.

3. An inefficient tax user is substantially penalized by the suggested difference in depreciation between owner occupied and leased structures.

Methodology. Dean Witter Reynolds has simulated the effect of the proposed tax law changes (and possible variations thereon) on real estate net lease transactions by structuring hypothetical net leases that have the same economic parameters for the investor under the proposed tax changes as net lease transactions currently available.[2]

The rentals thereby derived are then used to compare the cost of leasing with the cost of owning by:

1. Calculating the net after-tax cash flows of leasing;
2. Calculating the net after-tax cash flows of owning and financing conventionally with 100% mortgage debt; and
3. Discounting the difference between the two flows at the after-tax cost of debt to arrive at the net present value benefit (or disadvantage) of leasing.

The impact on real estate lease transactions of some alternative tax change scenarios was also analyzed. One specific alternative examined assumed (a) depreciable lives for owner-occupied property which correspond to the Administration's proposal, (b) depreciable lives for leased property which are the same as for owner occupied property, and (c) that there would be no individual tax cuts.

Conclusions. The economic impact of the Administation's proposal (and the variations thereon described above) on a sale and leaseback of a wholesale distribution center was analyzed for a full taxpaying

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2 These simulations, as noted, assume implementation of the Administration's proposed changes in individual tax rates, which changes would impact the economics of real estate leases since the Lessor is generally a partnership of individuals looking to tax shelter as part of their investment return. This shelter is less valuable if individual tax rates are lower.

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as well as for a company unable to utilize the tax benefits of ownership in the first three years after the in-service date of the property. The alternatives are analyzed for 1981 (assuming a retroactive application for depreciable life conventions to December 31, 1980) and for 1985 when the ACRS would be fully phased-in. A summary of the results is shown below:

Impact of ACRS on Typical Real Estate Lease

	Net Present Value Benefit (Disadvantage) of Leasing to Current Taxpayer*	Net Present Value Benefit (Disadvantage) of Leasing to Taxpayer Unable to Utilize Tax Benefits for 3 Years*
Current Tax Environment	$36,000	$52,000
Proposed Changes (1981)	(2,000)	27,000
Proposed Changes (1985)	(35,000)	8,000
Proposed Changes (1985) Except (i) Same depreciation for owner-occupied and leased structures; (ii) No personal tax rate reduction	$10,000	$56,000

For Full Taxpaying Companies, the effect of the tax changes during the phase-in period would be to make leases of new property somewhat less economically favorable than leases are in the current tax and economic environment. Leases would become dramatically unfavorable

* Per $1 million of structures cost. See Tables 7 and 8 for more detailed schedules and explanation.

for full taxpaying companies after the phase-in period. In 1981 the lease would show a slight net present value disadvantage. In 1985 this disadvantage would be even greater ($35,000 per $1 million of building cost) unless the Lessor could depreciate the property in the same manner as for an owner-occupied structure and if individual tax rates were not lowered.

For Companies Unable to Utilize Tax Benefits in a timely and efficient manner, leasing is an economically attractive form of financing. Under the proposed tax changes, leasing would be even more ecomomical than ownership for companies unable to use the increased benefits of ownership under ACRS. For a company which could not use the tax benefits of ownership for the first three years after the in-service date of the building, but which would instead carry forward the net operating losses, the financial benefits of leasing could be substantial. In 1981, if all of the proposed tax changes are implemented, leasing would have a net present value advantage over ownership of $27,000 (per $1 million of building cost).

In 1985 there is still an advantage ($8,000) but this is significantly improved (to $56,000) if there is no change in individual tax rates and if owner occupied and leased real estate are similarly treated.

Effect of ACRS on Personal Property (Equipment) Leases

Dean Witter Reynolds has also simulated the effect of the proposed tax law changes on personal property (equipment) lease transactions using methodology similar to that described above. There are two sub-

stantive differences in analysis for personal property leases. First, for items of machinery and equipment, the proposed ACRS does not differentiate in depreciation life between assets which are "used by their owners" and those which are leased. Secondly, since the vast majority of equipment lessors are corporations, the proposed tax rate reductions for individuals will have virtually no impact.

The impact of ACRS on a typical equipment lease is shown below. The common assumptions are (a) utility property such as a generating unit, (b) a 16 1/2% debt rate, and (c) a taxpayer unable to utilize tax benefits at all.

Impact of ACRS on a Typical Utility Plant
Lease when Utility Cannot Use Tax Benefits

Scenario	Net Present Value Benefit of Leasing per $1 million of Plant
Current Tax Environment	$291,000
Proposed Changes (1931)	$322,000
Proposed Changes (1985)	$379,000

As can be seen above, ACRS will dramatically improve the advantage of equipment leasing to a company unable to use tax benefits on a current basis.

WHAT ARE SOME OF THE SPECIAL IMPLICATIONS OF ACRS FOR THE ELECTRIC UTILITY INDUSTRY?

As mentioned in the Introduction, Dean Witter Reynolds has substantial involvement in arranging leases for utilities. I believe that there are several particular characteristics of the electric utility industry, and the relationship of leasing thereto, which need to be considered in implementing ACRS or any other form of accelerated depreciation, and it is in part because of this insight that I have been asked to speak before this Committee. The major points are as follows:

First, the capital requirements for the electric utility industry over the next few years are imposingly large. A recent study conducted by Data Resources Inc. for Dean Witter Reynolds indicates that net external capital requirements[3] for the electric utility industry in the three year period 1981-1983 will exceed $30 billion!

Second, many utilities cannot use on an immediate basis even the tax benefits which are available to them under existing depreciation policy. Further, the sizeable capital expenditures discussed above make it likely that this state of affairs will continue into the near future. Table 9 shows the current tax position of 80 major investor-owned companies included in the Dean Witter Reynolds' Utility Index (1979 data). Of these 80 utilities, 22, or 28%, paid no current 1979

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3 Defined as follows: net income plus depreciation and amortization, less dividends, less capital expenditures.

taxes and presumably would not benefit from additional tax benefits through accelerated depreciation. It is worth noting that the average of all 80 utilities had current taxes in 1979 equal to only 5.3% of 1979 net income versus a statutory rate of 46%.

Now I would be the first to admit that analysis of utility tax utilization is a very tricky business, especially based solely upon published data. However, the above conclusion about poor utilization of present tax benefits can, in general, be confirmed from two other sources. The Department of Energy's analysis of Class A & B privately owned electric utilities[4] shows that as of December 31, 1979 such utilities had unused investment tax credits totaling almost $2.4 billion. Additionally, we have examined the tax status of dividends of the 80 companies in the Dean Witter Reynolds Utility Index (see Table 10). This Table shows that 28 utilities (35% of the total) had tax losses sufficient to shelter some or all of the dividends paid to shareholders. For utilities which currently pay no taxes or which have unused investment tax credits, additional direct tax reduction through ACRS will likely provide little or no actual cash flow generation since they have no tax liability against which to take additional depreciation deductions.

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[4] Statistics of Privately Owned Electric Utilities in the United States - 1979, Classes A and B Companies. U.S. Dept. of Energy, Energy Information Administration, Washington, D.C.: U.S. Government Printing Office, 1980.

Third, however, (not to despair) leasing can have a positive impact for utilities and this should be improved substantially by ACRS assuming no special impediments to leasing are introduced. While we have not done a full scale systematic analysis of the economic impact of leasing under ACRS, our prior work with a number of utilities indicates that for many assets it is economic to lease. In one recent situation the present value savings from leasing was over $48 million for a $300 million plant. For another utility the saving was more than $14 million on a $215 million plant.[5] These results would have been even more dramatic had ACRS been in effect.[6]

The synthesis is of these four points is very simple: For many utilities ACRS will not provide direct assistance, but the availability of leasing (which transfers tax benefits to efficient users in return for lower financing costs to those companies which cannot use the tax benefits) ensures that the benefits of ACRS are realized by the utilities in an indirect manner.

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5 It is worth noting that DWR's model does not always indicate that the utility should lease. One recent study showed that, for a particular utility, ownership was clearly more cost effective than leasing. DWR so advised the client.

6 Complete and accurate analysis of leasing for a regulated utility is an extremely complicated and sophisticated process. Two factors, state by state regulatory variations and individual utility tax positions, can have a dramatic impact upon the results of a lease vs. own analysis. To illustrate, DWR spent nine months, several thousand man-hours, and about $250,000 worth of computer time developing a computer model to analyze with precision the lease/own decision for regulated utilities. Notwithstanding this, it is possible to state that changes in depreciable lives as contemplated by ACRS will have a dramatic impact on this decision. The analysis in this testimony is designed solely to highlight the relative changes which would be brought about by ACRS.

CONCLUSION

In adopting the proposed ACRS, in its present or a revised form, consideration should be given to simplification and modification of tax law and procedures to facilitate leasing. Additionally, consideration should be given to changes to allow investment in personal property (equipment) leases by individual investors.

I would respectfully suggest that the Senate address the problems of predictability and transferability of tax benefits, especially in the following major areas:

1. In respect of large projects, organizations frequently desire to participate as tenants-in-common to achieve economies of scale. The co-tenants, acting separately, should be permitted to arrange lease financing of all or any portion of their respective interests to optimize the use of tax benefits.

2. Although it would be difficult to legislate a definition of a "true lease" for tax purposes, it might be possible to amend the Internal Revenue Code expressly to permit certain terms of a true lease. For example, the parties might be permitted to agree on a price at which the Lessee could purchase the leased asset or the end of the lease term so long as the purchase price does not have the character of a "balloon" payment on a loan.

3. Again, although it would be difficult to legislate, the Code might be amended to distinguish between a true lease and a "service agreement". Alternatively, the Senate might reexamine the policy which is now reflected in Section 48(a)(4)-(5) of the Code.

4. The Senate, in amendments to the Code, might as a matter of policy direct the IRS to speed up the process of issuing private rulings on lease transactions or to adopt and publish a ruling which is not inconsistent with the decision of the Supreme Court in the Lyon case.

5. In order to facilitate independent financing for electric generation and transmission cooperatives currently regulated by the REA, Congress should encourage leasing by such cooperatives. Specifically, a Lessor leasing electric generating plants to such cooperatives should be entitled to the investment tax credit.

6. Expansion of the proposed 10-year property class for "factory buildings, retail stores, and warehouses used by their owners" to include "used by their owners or lessees".

Finally, the Senate might want to consider changes which would allow individual noncorporate investors to participate as Lessors. For practical purposes individuals do not at present invest in long-term equipment leases because of (a) the "at risk" rules which limit the losses of noncorporate net lessors to the amounts that such persons have at risk in the investment and (b) the unavailability of the investment tax credit to individuals other than for short-term "operating" leases. The reintroduction of individuals to lease investments would dramatically increase the funds available, through leasing, to help provide for accelerated business investing to increase productivity and provide economic growth in our country.

Thank you very much for your attention.

INTRODUCTION TO TABLES 1-6

Examples I and II, illustrated in Tables 1-6, compare the net cash flow effects and net present value advantage (or disadvantage) of leasing and owning for companies with marginal tax rates of 0% and 50%, respectively.

ASSUMPTIONS FOR EXAMPLES I AND II

Ownership Assumptions

Plant Cost:	$1,000,000
Depreciation Method:	Double Declining Balance switching to Sum of Years Digits
Depreciable Life for Tax Purposes:	22.5 years
Economic Life:	40 years
Salvage Value:	0
Investment Tax Credit As A Percent of Plant Cost:	9.5%
Principal Amount of Loan Used to Buy Plant:	$1,000,000
Interest Rate on Loan:	10%

Leasing Assumptions

Amount of Plant Leased:	$1,000,000 (100%)
Lease Term:	25 years with 5 year half rent renewal
Lease Rate:	6.52%
Lease Payments As A Percent of Plant Cost Per Year:	3.94% for 25 years 1.97% for 5 years
Repurchase Price As A Percent of Plant Cost at End of Lease Term:	25%
Depreciation Method on Repurchased Asset:	Straight Line
Depreciable Life on Repurchased Asset:	10 years

Example I — Table 1

CASH FLOW FROM OWNING ASSUMING 0% TAX RATE

Year Starting	Interest Expense	Depreciation Expense	Total Tax Deductible Expense	Investment Tax Credit	Taxes Paid	Debt Service	Cash Outflow From Buying
1/1984	$ 99,857	$ 88,889	$ 188,746	$0	$0	$ 105,379	$ 105,379
1/1985	99,263	80,988	180,250	0	0	105,656	105,656
1/1986	98,607	77,177	175,784	0	0	105,656	105,656
1/1987	97,885	73,412	171,297	0	0	105,656	105,656
1/1988	97,088	69,648	166,736	0	0	105,656	105,656
1/1989	96,210	65,883	162,093	0	0	105,656	105,656
1/1990	95,242	62,118	157,360	0	0	105,656	105,656
1/1991	94,174	58,353	152,527	0	0	105,656	105,656
1/1992	92,997	54,589	147,586	0	0	105,656	105,656
1/1993	91,699	50,824	142,523	0	0	105,656	105,656
1/1994	90,269	47,059	137,328	0	0	105,656	105,656
1/1995	88,692	43,294	131,986	0	0	105,656	105,656
1/1996	86,953	39,530	126,482	0	0	105,656	105,656
1/1997	85,036	35,765	120,801	0	0	105,656	105,656
1/1998	82,922	32,000	114,922	0	0	105,656	105,656
1/1999	80,592	28,235	108,827	0	0	105,656	105,656
1/2000	78,023	24,471	102,493	0	0	105,656	105,656
1/2001	75,190	20,706	95,896	0	0	105,656	105,656
1/2002	72,067	16,941	89,009	0	0	105,656	105,656
1/2003	68,625	13,177	81,801	0	0	105,656	105,656
1/2004	54,829	9,412	74,241	0	0	105,656	105,656
1/2005	60,644	5,647	66,[illegible]91	0	0	105,656	105,656
1/2006	56,030	1,882	57,913	0	0	105,656	105,656
1/2007	50,943	0	50,943	0	0	105,656	105,656
1/2008	45,335	0	45,335	0	0	105,656	105,656
1/2009	39,152	0	39,152	0	0	105,656	105,656
1/2010	32,336	0	32,336	0	0	105,656	105,656
1/2011	24,820	0	24,820	0	0	105,656	105,656
1/2012	16,535	0	16,535	0	0	105,656	105,656
1/2013	7,400	0	7,400	0	0	105,656	105,656
TOTALS	$2,169,414	$1,000,000	$3,169,414	$0	$0	$3,169,414	$3,169,414

Example I

Table 2

CASH FLOW FROM LEASING ASSUMING A 0% TAX RATE

Year Starting	Rent Expense	Depreciation of Repurchased Plant	Total Tax Deductible Expense	Investment Tax Credit	Taxes Paid	Rental Payment	Repurchase of Plant (a)	Cash Outflow From Leasing
1/1984	$ 79,115	$ 0	$ 79,115	$0	$0	$ 78,896	$ 0	$ 78,896
1/1985	78,896	0	78,896	0	0	78,896	0	78,896
1/1986	78,896	0	78,896	0	0	78,896	0	78,896
1/1987	78,896	0	78,896	0	0	78,896	0	78,896
1/1988	78,896	0	78,896	0	0	78,896	0	78,896
1/1989	78,896	0	78,896	0	0	78,896	0	78,896
1/1990	78,896	0	78,896	0	0	78,896	0	78,896
1/1991	78,896	0	78,896	0	0	78,896	0	78,896
1/1992	78,896	0	78,896	0	0	78,896	0	78,896
1/1993	78,896	0	78,896	0	0	78,896	0	78,896
1/1994	78,896	0	78,896	0	0	78,896	0	78,896
1/1995	78,896	0	78,896	0	0	78,896	0	78,896
1/1996	78,896	0	78,896	0	0	78,896	0	78,896
1/1997	78,896	0	78,896	0	0	78,896	0	78,896
1/1998	78,896	0	78,896	0	0	78,896	0	78,896
1/1999	78,896	0	78,896	0	0	78,896	0	78,896
1/2000	78,896	0	78,896	0	0	78,896	0	78,896
1/2001	78,896	0	78,896	0	0	78,896	0	78,896
1/2002	78,896	0	78,896	0	0	78,896	0	78,896
1/2003	78,896	0	78,896	0	0	78,896	0	78,896
1/2004	78,896	0	78,896	0	0	78,896	0	78,896
1/2005	78,896	0	78,896	0	0	78,896	0	78,896
1/2006	78,896	0	78,896	0	0	78,896	0	78,896
1/2007	78,896	0	78,896	0	0	78,896	0	78,896
1/2008	78,786	0	78,786	0	0	78,896	0	78,896
1/2009	39,448	0	39,448	0	0	39,448	0	39,448
1/2010	39,448	0	39,448	0	0	39,448	0	39,448
1/2011	39,448	0	39,448	0	0	39,448	0	39,448
1/2012	39,448	0	39,448	0	0	39,448	0	39,448
1/2013	39,338	0	39,338	0	0	39,448	0	39,448
1/2014	0	25,000	25,000	0	0	0	250,000	250,000
1/2015	0	25,000	25,000	0	0	0	0	0
1/2016	0	25,000	25,000	0	0	0	0	0
1/2017	0	25,000	25,000	0	0	0	0	0
1/2018	0	25,000	25,000	0	0	0	0	0
1/2019	0	25,000	25,000	0	0	0	0	0
1/2020	0	25,000	25,000	0	0	0	0	0
1/2021	0	25,000	25,000	0	0	0	0	0
1/2022	0	25,000	25,000	0	0	0	0	0
1/2023	0	25,000	25,000	0	0	0	0	0
TOTALS	$2,169,640	$250,000	$2,419,640	$0	$0	$2,169,640	$250,000	$2,419,640

(a) Repurchase of Plant for 25% of original cost at end of lease term.

Example I

Table 3

PRESENT VALUE ADVANTAGE (OR DISADVANTAGE) OF LEASING
ASSUMING A 0% TAX RATE

Year Starting	Cash Outflow From Leasing	Cash Outflow From Buying	Advantage (Disadvantage) of Leasing
1/1984	$ 78,896	$ 105,379	$ 26,483
1/1985	78,896	105,656	26,760
1/1986	78,896	105,656	26,760
1/1987	78,896	105,656	26,760
1/1988	78,896	105,656	26,760
1/1989	78,896	105,656	26,760
1/1990	78,896	105,656	26,760
1/1991	78,896	105,656	26,760
1/1992	78,896	105,656	26,760
1/1993	78,896	105,656	26,760
1/1994	78,896	105,656	26,760
1/1995	78,896	105,656	26,760
1/1996	78,896	105,656	26,760
1/1997	78,896	105,656	26,760
1/1998	78,896	105,656	26,760
1/1999	78,896	105,656	26,760
1/2000	78,896	105,656	26,760
1/2001	78,896	105,656	26,760
1/2002	78,896	105,656	26,760
1/2003	78,896	105,656	26,760
1/2004	78,896	105,656	26,760
1/2005	78,896	105,656	26,760
1/2006	78,896	105,656	26,760
1/2007	78,896	105,656	26,760
1/2008	78,896	105,656	26,760
1/2009	39,448	105,656	66,208
1/2010	39,448	105,656	66,208
1/2011	39,448	105,656	66,208
1/2012	39,448	105,656	66,208
1/2013	39,448	105,656	66,208
1/2014	250,000	0	-250,000
TOTALS	$2,419,640	$3,169,414	$749,774

NET PRESENT VALUE ADVANTAGE TO
LEASING (discounted at 10%): $252,790

Example II

Table 4

CASH FLOW FROM OWNING ASSUMING A 50% TAX RATE

Year Starting	Interest Expense	Depreciation Expense	Total Tax Deductible Expense	Investment Tax Credit	Taxes Paid (or Saved)	Debt Service	Cash Outflow (Inflow) From Buying
1/1984	$ 99,857	$ 88,889	$ 188,746	$95,000	$ -189,373	$ 105,379	$ -83,994
1/1985	99,263	80,988	180,250	0	-90,125	105,656	15,531
1/1986	98,607	77,177	175,784	0	-87,892	105,656	17,764
1/1987	97,885	73,412	171,297	0	-85,648	105,656	20,008
1/1988	97,088	69,648	166,736	0	-83,368	105,656	22,289
1/1989	96,210	65,883	162,093	0	-81,046	105,656	24,610
1/1990	95,242	62,118	157,360	0	-78,680	105,656	26,977
1/1991	94,174	58,353	152,527	0	-76,264	105,656	29,393
1/1992	92,997	54,589	147,586	0	-73,793	105,656	31,864
1/1993	91,699	50,824	142,523	0	-71,262	105,656	34,395
1/1994	90,269	47,059	137,328	0	-68,664	105,656	36,992
1/1995	88,692	43,294	131,986	0	-65,993	105,656	39,663
1/1996	86,953	39,530	126,482	0	-63,241	105,656	42,415
1/1997	85,036	35,765	120,801	0	-60,400	105,656	45,256
1/1998	82,922	32,000	114,922	0	-57,461	105,656	48,195
1/1999	80,592	28,235	108,827	0	-54,414	105,656	51,243
1/2000	78,023	24,471	102,493	0	-51,247	105,656	54,410
1/2001	75,190	20,706	95,896	0	-47,948	105,656	57,708
1/2002	72,067	16,941	89,009	0	-44,504	105,656	61,152
1/2003	68,625	13,177	81,801	0	-40,901	105,656	64,756
1/2004	64,829	9,412	74,241	0	-37,120	105,656	68,536
1/2005	60,644	5,647	66,291	0	-33,146	105,656	72,511
1/2006	56,030	1,882	57,913	0	-[illegible]8,956	105,656	76,700
1/2007	50,943	0	50,943	0	-25,472	105,656	80,185
1/2008	45,335	0	45,335	0	-22,668	105,656	82,989
1/2009	39,152	0	39,152	0	-19,576	105,656	86,080
1/2010	32,336	0	32,336	0	-16,168	105,656	89,488
1/2011	24,820	0	24,820	0	-12,410	105,656	93,246
1/2012	16,535	0	16,535	0	-8,267	105,656	97,389
1/2013	7,400	0	7,[illegible]00	0	-3,700	105,656	101,956
TOTALS	$2,169,414	$1,000,000	$3,169, 14	$95,000	$-1,679,707	$3,169,414	$1,489,707

Example II

Table 5

CASH FLOW FROM LEASING ASSUMING A 50% TAX RATE

Year Starting	Rent Expense	Depreciation From Re-purchased Plant	Total Tax Deductible Expense	Investment Tax Credit	Taxes Paid (or Saved)	Rental Payment	(a) Re-purchase of Plant	Cash Outflow (Inflow) From Leasing
1/1984	$ 79,115	$ 0	$ 79,115	$0	$ -39,558	$ 78,896	$ 0	$ 39,338
1/1985	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1986	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1987	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1988	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1989	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1990	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1991	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1992	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1993	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1994	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1995	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1996	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1997	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1998	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/1999	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2000	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2001	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2002	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2003	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2004	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2005	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2006	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2007	78,896	0	78,896	0	-39,448	78,896	0	39,448
1/2008	78,786	0	78,786	0	-39,393	78,896	0	39,503
1/2009	39,448	0	39,448	0	-19,724	39,448	0	19,724
1/2010	39,448	0	39,448	0	-19,724	39,448	0	19,724
1/2011	39,448	0	39,448	0	-19,724	39,448	0	19,724
1/2012	39,448	0	39,448	0	-19,724	39,448	0	19,724
1/2013	39,338	0	39,338	0	-19,669	39,448	0	19,779
1/2014	0	25,000	25,000	0	-12,500	0	250,000	237,500
1/2015	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2016	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2017	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2018	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2019	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2020	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2021	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2022	0	25,000	25,000	0	-12,500	0	0	-12,500
1/2023	0	25,000	25,000	0	-12,500	0	0	-12,500
TOTALS	$2,169,640	$250,000	$2,419,640	$0	$-1,209,820	$2,169,640	$250,000	$1,209,820

(a) Repurchase of Plant for 25% of original cost at end of lease term.

Example II

Table 6

PRESENT VALUE ADVANTAGE (OR DISADVANTAGE) OF LEASING ASSUMING A 50% TAX RATE

Year Starting	Cash Outflow (Inflow) From Leasing	Cash Outflow (Inflow) From Buying	Advantage (Disadvantage) of Leasing
1/1984	$ 39,338	$ -83,994	$-123,333
1/1985	39,448	15,531	-23,917
1/1986	39,448	17,764	-21,684
1/1987	39,448	20,008	-19,440
1/1988	39,448	22,289	-17,159
1/1989	39,448	24,610	-14,838
1/1990	39,448	26,977	-12,471
1/1991	39,448	29,393	-10,055
1/1992	39,448	31,864	-7,584
1/1993	39,448	34,395	-5,053
1/1994	39,448	36,992	-2,456
1/1995	39,448	39,663	215
1/1996	39,448	42,415	2,967
1/1997	39,448	45,256	5,808
1/1998	39,448	48,195	8,747
1/1999	39,448	51,243	11,795
1/2000	39,448	54,410	14,962
1/2001	39,448	57,708	18,260
1/2002	39,448	61,152	21,704
1/2003	39,448	64,756	25,308
1/2004	39,448	68,536	29,088
1/2005	39,448	72,511	33,063
1/2006	39,448	76,700	37,252
1/2007	39,448	80,185	40,737
1/2008	39,503	82,989	43,486
1/2009	19,724	86,080	66,356
1/2010	19,724	89,488	69,764
1/2011	19,724	93,246	73,522
1/2012	19,724	97,389	77,665
1/2013	19,779	101,956	82,178
1/2014	237,500	0	-237,500
1/2015	-12,500	0	12,500
1/2016	-12,500	0	12,500
1/2017	-12,500	0	12,500
1/2018	-12,500	0	12,500
1/2019	-12,500	0	12,500
1/2020	-12,500	0	12,500
1/2021	-12,500	0	12,500
1/2022	-12,500	0	12,500
1/2023	-12,500	0	12,500
TOTALS	$1,209,820	$1,489,707	$279,887

NET PRESENT VALUE DISADVANTAGE TO LEASING (discounted at 5%): $65,286

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INTRODUCTION TO TABLES 7 AND 8

Tables 7 and 8 analyze the impact of the proposed tax changes on the net lease of a wholesale distribution center for (a) a company which is a current taxpayer and (b) a company which is unable to utilize tax benefits for three years.

The principal method of analysis used is a comparison of the net present value of owning with that of leasing.

A further method, which is also utilized in the accompanying Tables, of analyzing the benefit (or detriment) of leasing is through calculating a "breakeven" residual. The breakeven residual is the dollar amount which, if the lessee were to repurchase the building at the end of the lease term, would make the cost of leasing equivalent to the cost of owning. The breakeven residual also includes the value of future depreciation tax shields since, if the leased property is purchased, the new owner would be able to depreciate the purchase price of the property and derive a tangible after-tax cash flow benefit. If the prospective lessee determines that the cost of repurchasing the property at the end of the lease term will be lower than the breakeven residual then leasing would be an economically attractive form of financing.

TABLE 7

Impact of Proposed Tax Changes on the Net Lease of a Wholesale Distribution Center[1]

Scenario	Lease Rate[2]	Basis Point Spread From Lessor's Debt Rate[3]	Primary Term Rentals[4] Rents	Primary Term Rentals[4] Years	Net Present Value Benefit (Disadvantage) of Leasing[5]	Breakeven Residual[6]
A. Current Market and Tax Environment	12.15%	235	7.8%	1-3	$38,000	$763,000
			14.5%	4-10		
			19.25%	11-20		
B. Proposed Changes Phasing - In (1981)	10.70%	380	5.5%	1-4	(2,000)	NA
			14.5%	5-10		
			19.25%	11-20		
C. Proposed Changes Fully Implemented (1985) Except: i. No Difference In Depreciation Between Owner Occupied and Leased Structures, and ii. No Reduction In Personal Tax Rates	9.50%	500	2.0%	1-4	10,000	242,000
			14.5%	5-10		
			19.25%	11-20		
D. Proposed Changes Fully Implemented (1985) Except: i. No Reduction In Personal Tax Rates	10.15%	435	4.0%	1-4	(26,000)	NA
			14.5%	5-10		
			19.25%	11-20		
E. Proposed Changes Fully Implemented (1985)	10.35%	415	4.5%	1-4	$(35,000)	NA
			14.5%	5-10		
			19.25%	11-20		

1 The Wholesale Distribution Center is assumed to consist of 70% real property with a depreciable life of 29 years and 30% personal property with a depreciable life of 29 years. The Lessee is assumed to keep the ITC associated with the personal property.

2 Lease rates are rounded to the nearest 5 basis points.

3 Assumes a 20 year mortgage with an interest rate of 14.5%, payable monthly.

4 Rents are paid semiannually-in-arrears and are based on 20 year maturity debt, 10 year interest-only payments, fully amortizing thereafter.

5 Per $1,000,000 of structure cost. Discounted at the after tax debt rate of 7.83% (14.5% x (1-.46)).

6 Calculated using a 15% cost of capital and taking into account the future depreciation tax shields on acquired structures at the end of the primary lease term. In the current tax environment repurchased structures are assumed to be depreciated over 20 years using straight line depreciation. Under the proposed changes the repurchased structures are assumed to be depreciated over 10 years using 200%/SYD.

DEAN WITTER REYNOLDS INC.

TABLE 8

Impact of Proposed Tax Changes on Full Taxpayer and on Taxpayer Unable to Utilize Tax Benefits in Years 1-3 after Building In-Service[1]

Scenario	Lease Rate	Full Tax Payer		Taxpayer Unable to Utilize Tax Benefits in Years 1-3	
		Net Present Value Advantage (Disadvantage) of Leasing	Breakeven Residual	Net Present Value Advantage (Disadvantage) of Leasing	Breakeve Residual
A. Current Market and Tax Environment	12.15%	$ 36,000	$763,000	$52,000	$1,105,00
B. Proposed Changes Phasing - In (1981)	10.70%	(2,000)	NA	27,000	667,00
C. Proposed Changes Fully Implemented (1985) Except: i. No Difference in Depreciation Between Owner Occupied and Leased Structures, and ii. No Reduction in Personal Tax Rates	9.50%	10,000	$242,000	56,000	1,384,00
D. Proposed Changes Fully Implemented (1985) Except: i. No Reduction In Personal Tax Rates	10.15%	(26,000)	NA	13,000	445,00
E. Proposed Changes Fully Implemented	10.35%	$(35,000)	NA	$ 8,000	$ 198,00

1. The property, financing and breakeven assumptions are the same as those used in Exhibit I. The Lessee is assumed to carry forward net operating losses from the depreciation and interest expense in the ownership case and from the lease payments in the leasing case, for 3 years and then utilize the net operating loss in the fourth year.

DEAN WITTER REYNOLDS INC.
Utility Index

Table 9

CURRENT TAXES 1979 DATA

	1979 EFFECTIVE TAX RATE	1979 CURRENT TAXES	1979 NET INCOME	CURRENT TAX AS %OF NET INCOME
	%	$ MIL	$ MIL	%
ALLEGHENY POWER	30.00	0.40	80.10	0.70
AMERICAN ELECTRIC POWER	25.00	22.30	303.60	6.04
ARIZONA PUBLIC SERVICE	11.00	6.00	121.60	5.30
ATLANTIC CITY ELECTRIC	35.00	-1.60	34.30	-4.09
BALTIMORE GAS & ELECTRIC	36.00	9.90	126.30	7.27
BOSTON EDISON	43.00	3.50	58.60	5.64
CAROLINA POWER & LIGHT	30.00	1.50	153.20	0.97
CENTRAL & SOUTHWEST	39.00	-15.20	152.30	-11.09
CENTRAL HUDSON GAS & ELECTRIC	10.00	-0.70	21.70	-3.33
CENTRAL ILLINOIS LIGHT	47.00	12.10	33.06	26.03
CENTRAL ILLINOIS PUBLIC SERVICE	40.00	0.70	51.30	14.50
CINCINNATI GAS & ELECTRIC	20.00	-6.30	85.70	-7.93
CLEVELAND ELECTRIC ILLUMINATING	20.00	7.60	113.50	6.20
COMMONWEALTH EDISON	29.00	61.00	296.70	17.24
CONSOLIDATED EDISON	31.00	77.20	325.90	19.25
CONSUMERS POWER	12.00	-3.70	283.00	-1.05
DAYTON POWER & LIGHT	10.00	2.60	61.50	4.06
DELMARVA POWER	31.00	-4.50	53.40	-9.26
DETROIT EDISON	29.00	5.10	176.00	2.02
DUKE POWER	26.00	26.20	274.00	0.70
DUQUESNE LIGHT	34.00	2.30	82.20	2.72
EL PASO ELECTRIC	34.00	1.20	23.20	0.92
FLORIDA POWER CORP	40.00	24.10	73.50	24.69
FLORIDA POWER & LIGHT	43.00	0.90	204.70	4.17
GENERAL PUBLIC UTILITIES	40.00	3.00	95.00	3.04
GULF STATES UTILITIES	31.00	-9.50	84.20	-12.72
HAWAIIAN ELECTRIC	40.00	17.65	25.30	41.63
HOUSTON INDUSTRIES	40.00	18.20	161.00	10.11
IDAHO POWER	20.00	-0.30	31.30	-0.97
ILLINOIS POWER	35.00	14.20	91.30	13.46
INDIANAPOLIS POWER & LIGHT	46.00	27.60	52.40	34.50
KANSAS GAS & ELECTRIC	20.00	-2.30	29.20	-0.55
KANSAS POWER & LIGHT	33.00	1.20	36.06	3.16
KENTUCKY UTILITIES	47.00	-0.60	30.00	-1.99
LONG ISLAND LIGHTING	1.00	-4.00	161.70	-2.54
LOUISVILLE GAS & ELECTRIC	46.00	0.50	30.50	1.61
MIDDLE SOUTH UTILITIES	NEG	-1.50	182.10	-0.83
MINNESOTA POWER & LIGHT	30.60	0.03	35.00	0.09
MONTANA POWER	27.00	4.10	33.50	10.90
NEVADA POWER	32.00	-2.70	27.00	-10.76
NEW ENGLAND ELECTRIC SYSTEM	39.00	10.00	73.50	11.90
NEW YORK STATE GAS & ELECTRIC	17.00	6.60	87.40	7.02
NIAGARA MOHAWK	12.00	1.60	156.00	1.02
NORTHEAST UTILITIES	25.00	6.50	80.00	7.45
NORTHERN INDIANA PUBLIC SERVICE	42.00	3.90	76.00	4.03
NORTHERN STATES POWER	40.00	12.70	120.70	9.52
OHIO EDISON	21.00	3.70	134.00	2.67
OKLAHOMA GAS & ELECTRIC	34.00	2.70	14.00	15.43
ORANGE & ROCKLAND UTILITIES	37.00	6.10	24.90	19.60
PACIFIC GAS & ELECTRIC	16.00	-76.00	250.20	-41.71
PACIFIC POWER & LIGHT	23.00	-0.00	112.50	-0.72
PENNSYLVANIA POWER & LIGHT	22.00	14.30	102.20	7.20
PHILADELPHIA ELECTRIC	19.00	2.00	194.50	1.42
PORTLAND GENERAL ELECTRIC	23.00	0.40	46.10	0.06
POTOMAC ELECTRIC POWER	37.00	12.60	84.40	12.99
PUBLIC SERVICE OF COLORADO	32.00	2.40	55.00	4.12
PUBLIC SERVICE OF INDIANA	41.00	19.60	122.90	13.75
PUBLIC SERVICE OF NEW MEXICO	29.00	3.43	54.00	5.90
PUBLIC SERVICE ELECTRIC & GAS	35.00	16.40	233.30	6.57
PUGET SOUND POWER & LIGHT	11.00	1.70	44.30	3.70
ROCHESTER GAS & ELECTRIC	4.00	-4.50	39.60	-12.02
SAN DIEGO GAS & ELECTRIC	6.00	-1.70	70.20	-2.40
SAVANNAH ELECTRIC POWER	33.00	-0.10	6.10	-1.67
SIERRA PACIFIC POWER	32.00	1.60	21.00	7.08
SOUTH CAROLINA ELECTRIC	32.00	3.26	55.70	5.43
SOUTHERN CALIFORNIA EDISON	10.00	17.50	346.20	4.01
SOUTHERN COMPANY	43.00	12.40	219.10	5.36
SOUTHERN INDIANA GAS & ELECTRIC	44.00	1.10	14.40	7.16
SOUTHWESTERN PUBLIC SERVICE	5.00	-0.60	40.00	-1.52
TAMPA ELECTRIC	42.00	9.20	35.90	20.40
TEXAS UTILITIES	37.00	-15.60	211.10	-6.09
TOLEDO EDISON	22.00	2.20	50.60	3.62
TUCSON ELECTRIC POWER	20.00	4.90	53.50	0.39
UNION ELECTRIC	25.00	-12.40	110.10	-11.73
UTAH POWER &LIGHT	35.00	-1.00	84.70	-1.19
VIRGINIA ELECTRIC & POWER	26.00	0.40	196.50	4.16
WASHINGTON WATER POWER	17.70	0.90	27.40	3.10
WISCONSIN ELECTRIC POWER	44.00	15.90	82.50	16.16
WISCONSIN POWER & LIGHT	51.00	10.90	33.00	36.42
WISCONSIN PUBLIC SERVICE	53.00	26.90	35.20	37.25
INDUSTRY AVERAGE	30.34	5.72	101.67	5.33

Source: Utility Insights, March 1981
Dean Witter Reynolds Inc.

DEAN WITTER REYNOLDS INC.
Utility Index

Table 10

Tax Status of Dividends Paid in 1980

	1980 Payments ($)		
	Total Paid	Income Portion	Non-Taxable
Allegheny Power	1.80	1.80	-
American Electric Power	2.23	1.58	0.65
Arizona Public Service	2.06	0.82	1.24
Atlantic City Electric	1.90[1]	1.78	0.12
Baltimore Gas & Electric	2.47	2.47	-
Boston Edison	2.72	2.12	0.60
Carolina Power & Light	2.16	2.16	-
Central & Southwest	1.50	1.50	-
Central Hudson Gas & Electric	2.18	0.22	1.96
Central Illinois Light	1.70	1.70	-
Central Illinois Public Service	1.39	1.39	-
Cincinnati Gas & Electric	2.02	2.02	-
Cleveland Electric Illuminating	2.00	-	2.00
Commonwealth Edison	2.60	0.21	2.39
Consolidated Edison	2.68	2.68	-
Consumers Power	2.36[1]	0.44	1.92
Dayton Power & Light	1.74	0.26	1.48
Delmarva Power	1.48	1.48	-
Detroit Edison	1.60	-	1.60
Duke Power	1.95	1.95	-
Duquesne Light	1.80[1]	0.54	1.26
El Paso Electric	1.13	1.13	-
Florida Power Corp	1.94	1.94	-
Florida Power & Light	2.64	2.64	-
General Public Utilities	-	-	-
Gulf States Utilities	1.39	1.39	-
Hawaiian Electric	2.49	2.49	-
Houston Industries	2.68	2.68	-
Idaho Power	2.46	2.46	-
Illinois Power	2.33	2.33	-
Indianapolis Power & Light	2.21	2.21	-
Kansas Gas & Electric	1.965	1.965	-
Kansas Power & Light	2.02	2.02	-
Kentucky Utilities	2.12	2.12	-
Long Island Lighting	1.82	-	1.82
Louisville Gas & Electric	2.08	2.08	-
Middle South Utilities	1.58	0.03	1.55
Minnesota Power & Light	2.04	2.04	-
Montana Power	2.12	2.12	-
Nevada Power	2.27	2.27	-
New England Electric System	2.36	2.36	-
New York State Gas & Electric	1.82	-	1.82
Niagara Mohawk	1.50	0.53	0.97
Northeast Utilities	1.10	0.12	0.98
Northern Indiana Public Service	1.50	1.50	-
Northern States Power	2.35	2.35	-
Ohio Edison	1.76	-	1.76
Oklahoma Gas & Electric	1.60	1.60	-
Orange & Rockland Utilities	1.58[1]	0.47	1.01
Pacific Gas & Electric	2.56	2.56	-
Pacific Power & Light	2.04	1.12	0.92
Pennsylvania Power & Light	2.10	-	2.10
Philadelphia Electric	1.80	0.95	0 85
Portland General Electric	1.70	0.63	1 [illegible]
Potomac Electric Power	1.46	1.46	
Public Service of Colorado	1.60	1.60	
Public Service of Indiana	2.44	2.44	
Public Service of New Mexico	2.04	2.04	
Public Service Electric & Gas	2.29	0.47	1.82
Puget Sound Power & Light	1.64[1]	0.86	0.78
Rochester Gas & Electric	1.49	-	1.49
San Diego Gas & Electric	1.54	0.08	1.46
Savannah Electric Power	1.20	1.20	-
Sierra Pacific Power	1.43	1.43	-
South Carolina Electric	1.725	1.725	-
Southern California Edison	2.78	2.78	-
Southern Company	1.56	1.56	-
Southern Indiana Gas & Electric	1.68	1.68	-
Southwestern Public Service	1.305	1.305	-
Tampa Electric	1.33	1.33	
Texas Utilities	1.73	1.73	-
Toledo Edison	2.20	-	2.20
Tucson Electric Power	1.52	1.52	-
Union Electric	1.48	1.48	-
Utah Power & Light	1.88	1.88	-
Virginia Electric & Power	1.60	-	1.60
Washington Water Power	2.16	2.16	-
Wisconsin Electric Power	2.685	2.685	-
Wisconsin Power & Light	1.88	1.88	-
Wisconsin Public Service	1.77	1.77	-

[1] There was some variation in the tax treatment of the quarterly dividends

Source: Moody's Dividend Record, Volume 51, No. 21, Section 2, Friday, March 13, 1981

Statement of
Jerry L. Oppenheimer
On Behalf of Comdisco, Inc.
Before the
Senate Committee on Finance

I am Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt here in Washington. I appear today on behalf of Comdisco, Inc. of Rosemont, Illinois, a New York Stock Exchange company and the world's largest remarketer of IBM computer equipment.

In summary, we are concerned with the application of the Administration's proposed accelerated cost recovery deduction to sales and lease-backs to pre-1981 users of short life property, such as computers. This is a relatively narrow problem, but an important one to taxpayers such as Comdisco.

Specifically, proposed Code section 168(f)(5)(A) (section 201(a) of S. 683) would provide a significantly smaller deduction than that available under current law in the case of a sale and lease-back of personal property which presently enjoys a relatively short life. It may be appropriate for proposed Code section 168(f)(5)(A) to deny faster cost recovery to transactions involving current users or related parties, but it is not appropriate to reduce the deduction permitted under current law for sale and lease-back transactions.

Under the Administration's proposal, cost recovery for most tangible property involved in sale and lease-back transactions

with pre-1981 users would be restricted to the equivalent of straight-line depreciation over ten years (proposed Code sections 168(f)(5)(A) and 312(k)(3)). Under the current CLADR system, used computer equipment, as well as some other kinds of used property, can be depreciated over as few as five years using the 150% declining balance method. Many leasing companies use even shorter lives for used computer equipment on a facts and circumstances basis.

Thus, the proposal would significantly penalize sale and lease-back transactions involving pre-1981 users of equipment which presently enjoys a short depreciable life. It is important to note that there are significant non-tax reasons for such transactions. For example, a lessee from IBM of computer equipment may exercise an option to purchase the equipment, apply its "rental credits" to reduce the purchase price of the equipment, and then simultaneously resell the equipment to and lease it from Comdisco or some other leasing company. In such transactions, the user enjoys the benefit of rental credits, protects itself against technological obsolescence by leasing rather than purchasing for its own account, and may enhance its financial statements.

Similarly, leasing companies such as Comdisco may make better use of available capital by selling equipment to investors and leasing it back for sublease to users. This is a preferred means for a leasing company to raise additional capital for new

acquisitions and is similar to a savings and loan association selling its portfolio of mortgages. If the new owner must use ten year straight-line depreciation, the market for such transactions would be significantly restricted, and the equipment leasing industry generally might be severely affected.

These transactions contribute to capital investment and business growth. Thus, the proposed restriction runs counter to the underlying purpose of the Administration's cost recovery proposals.

Any leasing company involved in these transactions would be affected by the Administration's proposal, but the burden will fall heaviest on those companies which specialize in short life property. Their aggregate taxes may be substantially increased.

Comdisco estimates that, during the first four months of 1981, the dollar value of its sale and lease-back transactions with pre-1981 users of computer equipment is about twice that of the corresponding period of 1980. Nevertheless, Comdisco has calculated that, if its aggregate 1980 acquisitions (i.e., all sales and lease-backs and other types of acquisitions) were repeated in 1981, under the Administration's proposal, its depreciation on its 1981 acquisitions would be reduced by 32% in 1981, 30% in 1982, and 10% in 1983.

It is important to note that the above figures take into account greater depreciation on Comdisco's other assets. That is, this adverse treatment of assets acquired in sale and lease-

back transactions involving pre-1981 users would not be offset by faster recovery on other assets. Similarly, the decrease in Comdisco's depreciation would not be offset by an increase in its investment tax credits, because all of Comdisco's new property acquisitions now qualify for the full investment tax credit and the increased investment tax credit for used property would be insignificant.

Obviously, the effect of the proposal on sale and lease-back transactions with pre-1981 users is punitive and could, at best, cause many leasing companies which specialize in short life property to revise significantly their leasing activities. Proposed Code section 167(r)(9)(A) (section 202(a) of S. 683) would prohibit virtually identical transactions involving real property from taking advantage of the new rapid cost recovery allowances, but it would also permit depreciation over 30 years, which is comparable to present law. This suggests a general intent not to penalize taxpayers engaged in sale and lease-back transactions and that the severe adverse effects on sale and lease-back transactions of short life tangible property was unintended.

If there is a bright side, it is that the problem would be of only limited duration. Because computers have short lives and because we are concerned only with acquisitions of used property, the severe adverse effects would last about four years. Thereafter, the amount of short life pre-1981 used property acquired in any year would probably be minimal.

Thus, we recommend that either of the following solutions be adopted:

Our preference would be to apply the proposed accelerated five year cost recovery to short life property which is acquired in sale and lease-back transactions with pre-1981 users; that is, enactment of an exception to section 168(f)(5)(A) for sale and lease-back property which currently has a CLADR lower limit of five years or less.

A second acceptable solution would be enactment of a four year transition rule which would permit taxpayers to elect the same depreciation as permitted under current law on sale and lease-back property transactions involving pre-1981 users if the property currently has a CLADR lower limit of five years or less.

Neither of these suggestions would, in the first two years, significantly accelerate the depreciation Comdisco currently claims on assets acquired in sale and lease-back transactions with pre-1981 users. Nor would either suggestion damage the overall fabric of the proposed accelerated cost recovery system. Both are limited in duration, and transition rules are currently proposed for all property which has a CLADR lower limit of more than five years. Finally, because either transition rule would apply only to transactions involving short life

property, there would be no opportunity for the abuse which section 168(f)(5)(A) is designed to prevent -- that is, manipulative sales and lease-backs of long life property in order to take advantage of the proposed faster cost recovery system.

We would welcome the opportunity to work with the Committee and its staff on technical language to implement either suggestion, and I will be happy to answer any questions. Thank you.

Senator SYMMS. Thank you.

Senator DURENBERGER. Senator Long, do you have any additional questions?

Senator LONG. No thanks.

Senator DURENBERGER. Mr. Finfer, before you leave Senator Grassley had two questions. You don't have to answer them, perhaps I'll just hand them to you and you can respond to them as part of the record.

1212 Avenue of the Americas
New York, New York 10036
212-944-2090

May 20, 1981

The Honorable Charles E. Grassley
United States Senate
Russell Senate Office Building 344
Washington, D.C. 20510

Dear Senator Grassley:

After my testimony on behalf of the American Association Of Equipment Lesssors (AAEL) was completed yesterday, Senator Durenberger (who was acting as Chairman in Senator Dole's temporary absence) noticed the two questions you had jotted down for me prior to your having to temporarily leave the hearing (copy attached). Accordingly, Senator Durenberger indicated that if I would be kind enough to respond to your questions in writing, he would see to it that your questions together with my responses, were made part of the permanent record. Your questions, and my answers, follow:

QUESTION NUMBER 1:

The Air Transport Association suggested that only one-half of the investment tax credit is passed through to the lessee. Is that a fair estimate?

ANSWER:

No it is not. In the big ticket leveraged leasing market segment of our industry (which was the area which my testimony and the questions focused on), 100% of the present value of all tax benefits received by lessors, is passed through to the lessee in the form of lower rentals.

In the mid 1960's, when leveraged leasing began to come into its own as a viable and attractive financing alternative, it was not unusual to find lessors who were able to increase their own profit margins by not passing through all of the tax benefits of ownership (investment tax credits and depreciation), to the lessee. For at least the last five to seven years, however, this situation has been totally reversed. Lessees have become at least as sophisticated (if not more sophisticated) than lessors. Accordingly, the rule today is that lessees sit down at their computers and price and structure a transaction to their liking. They then prepare a "bid request", the size and specificity of which would put GSA bid requests to shame, and send them out to a "select" group of fifty or so lessors to bid on. After the bids have been received by the lessee, and evaluated, the lessee then decides if any of them meet its requirements. If one of

the bids submitted does fit the lessee's requirements, it notifies the lessor and they begin drawing up a memorandum of agreement which becomes the basis for the actual lease agreement. If, on the other hand, none of the bid requests suits the lessee, it then sends out bid requests to another group of lessors. This highly competitive environment is the "real world" in which the leasing industry lives, and anything brought up in testimony yesterday that suggests the opposite, flys in the face of reality.

QUESTION NUMBER 2:

The Air Transport Association indicated this morning that leasing is less actractive than ownership. Why then do many profitable companies lease property?

ANSWER:

The reason so many profitable companies, including each and every one of the "Fortune 500" companies, leases property, is because leasing has proven itself to be a viable and highly competitive source of intermediate and long term financing.

Long ago, sophisticated corporate financial managers began to realize that it was not the mere ownership of property that gave rise to, or created wealth, or jobs. Rather, it was the productive use to which the property could be put that gave that property its real value. Evidently this is something that the gentleman who testified on behalf of the steel industry yesterday, has not yet learned. If I recall his testimony, he referred to leasing as some sort of a "scheme" or "device". In fact, I can see this gentleman now, walking through a shut-down, old, outdated, non-competitive steel mill with his son saying, "We own all this".

Each and every one of the "Fortune 500" companies leases some of the equipment it uses. So too do farmers, hospitals (especially non profit hospitals where the lease transactions generate no investment tax credit whatsoever), manufacturers, distributors, and every manner of small business in this country.

Last year (1980), equipment lessors purchased nearly $40 billion worth of capital equipment for lease to others. These investments in personal property (according to an AAEL survey) are broken down approximately, as follows:

Production equipment (machine tools, etc.)	$6.6 billion
Computers	$6.5 billion

Office machinery other than computers (copiers, word processors, etc.)	$6.3 billion
Transportation equipment	$6.2 billion
Miscellaneous	$3.3 billion
Non-productive equipment (recreational, etc.)	$3.2 billion
Medical equipment	$3.0 billion
Construction equipment	$2.5 billion
Agricultural equipment (tractors, irrigation equipment, etc.)	$2.4 billion

I hope you will take note that of the nearly $40 billion worth of equipment that the industry purchased, only $6.2 billion represents transportation equipment. While a fair amount of that $6.2 billion represents equipment leased to airlines and railroads that were not capable of utilizing the tax benefits of ownership on a current basis, the balance--not only of the transportation equipment category but of the $40 billion worth of equipment purchases as well--was leased to companies that were able to use their tax benefits on a current basis. The representative of the ATA indicated that approximately 25% of the airlines' commercial plane fleet was leased. There is little doubt in my mind that if they would have leased more of their fleet, they wouldn't be suffering from an excess of unused investment tax credits today.

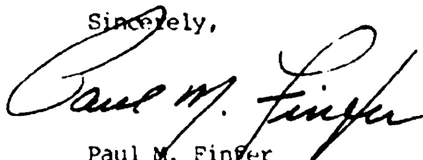
I remember going out on a sales call when I was new to the leasing business and having the purchasing director for the company I was visiting say to me, "Boy, things have really changed around here. The last financial vice president we had made us purchase all of our assets. Now we have a new chief financial officer and he put in a computer program. Now we lease all of our assets". When I left that sales call, I can't help but remember feeling sorry for that company in having picked one bad financial officer after another. The lease/purchase decision is never always one way, or the other, across the board. Sometimes it is more cost efficient to lease and sometimes it is not. It is important to note, however, that the answer does not necessarily have any direct relation to whether or not the perspective lessee can utilize the tax benefits of ownership on a current basis.

In closing, I would like to respond to some of the comments made on behalf of "refundable" investment tax credits. "Refundable" investment tax credits are the least efficient of any of the incentives currently being proposed as a means to spur new investment in capital equipment. To support this claim, I have asked the AAEL to forward to you (under separate cover), a copy of a study prepared by (Andrew) Brimmer And Company and Data Resources Inc., and ask that you be kind

enough to also make it part of the permanent record of the Committee hearings. (With respect thereto, let me specifically call your attention to pages 1 through 7 and 55 through 63).

I thank you for your questions and for having been given the opportunity to appear before the Senate Finance Committee. Additionally, I would like to ask that if you have any further questions, that you feel free to call or write me. It would be my pleasure to help.

Sincerely,



Paul M. Finger
President

PMF/ae
Enclosure

cc:

The Honorable Bob Packwood
The Honorable William V. Roth, Jr.
The Honorable John C. Danforth
The Honorable John H. Chafee
The Honorable H. John Heinz, III
The Honorable Malcolm Wallop
The Honorable David Durenberger
The Honorable William L. Armstrong
The Honorable Steven D. Symms
The Honorable Russell B. Long
The Honorable Harry F. Byrd, Jr.
The Honorable Lloyd M. Bentsen
The Honorable Spark M. Matsunaga
The Honorable Daniel Patrick Moynihan
The Honorable Max Baucus
The Honorable David L. Boren
The Honorable Bill Bradley
The Honorable George J. Mitchell

The Honorable Robert Lighthizer
The Honorable J. Michael Stern

Our next panel is our 2:00 p.m. panel—don't look at the clock—a panel consisting of Dale W. Jorgenson, professor of economics at Harvard University, George A. Strichman, chairman of the Committee for Effective Capital Recovery and David G. Raboy, director of research, Institute for Research on the Economics of Taxation.

STATEMENT OF DALE W. JORGENSON, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Dr. JORGENSON. My name is Dale Jorgenson. I am a professor of economics at Harvard.

I wish to make two simple points, gentlemen. One is that the problem with capital recovery is due to inflation. Given the variations in the rate of inflation, there is no way to solve this problem by means of an accelerated capital recovery system like the 10-5-3 proposal that has been advanced by President Reagan.

The solution for the problem of inflation and capital recovery is provided by the first year capital recovery system. This system would provide first year allowances that would permit full capital recovery in the same year that an investment takes place, so that the tax deductions would be completely unaffected by inflation.

These points are made at greater length in a prepared statement that I have submitted for the record entitled "The First Year Capital Recovery System" and dated May 19, today. I would like to submit this statement, which looks like this for the record, if I may——

Senator DURENBERGER. Without objection. That statement and the full statement of all the members of this panel will be made a part of the record.

Dr. JORGENSON. Thank you very much.

The key concept that is employed in my testimony is one that is not unfamiliar to this panel and that is the idea of an effective tax rate.

We are all familiar with the fact that the Internal Revenue Code provides a statutory rate for taxation which in the corporate part of the Code is 46 percent under current law for large corporations.

The effective tax rate is the tax rate that people actually pay and it depends not only on the statutory rate, but also on capital consumption allowances, the investment tax credit, tax deductibility of interest and a lot of other provisions.

The importance of the concept of the effective tax rates derives the simple fact that the common characteristic of all tax systems that lead to an efficient allocation of capital is that they have the same effective tax rate on all assets.

That condition is the one that assures us that for every dollar of investment, there will be a maximum possible increase in the gross national product, or to put it another way, by investing efficiently we can make sure that investment will enhance productivity rather than reduce it.

Let me give you two examples of tax systems that would lead to efficient capital allocation. One of them is to allow capital recovery equal to economic depreciation. Economic depreciation is equal to the decline in assets with age.

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This system would result in an effective tax rate that is the same for all assets and would be precisely the statutory rate provided in the code, 46 percent in the corporate part of the Code.

A second tax system that would result in equal effective tax rates is to allow immediate expensing and, of course, no corresponding deductibility of interest and no investment tax credit, by treating capital outlays like all other business expenses, simply writing them off in the year in which the investment is made.

This system, of course, would amount to abolishing the corporate income tax because it would produce the tax rate that taxpayers would actually pay to zero. Now, in fact, any combination of these systems would result in an efficient allocation of capital. So, it is possible to choose an effective rate anywhere between zero and the statutory rate by simply choosing a combination of these two approaches. Therefore, arriving at an efficient system for capital allocation is not an insuperable problem.

But now what about the current law, what precisely is the effective tax rate under current law and how does that compare with the President's proposal and how does it compare with the proposal considered before this Committee in the last Congress, the so-called 2-4-7-10 system?

At 1980 rates of inflation, current law provides an effective tax rate of 24 percent which is a little more than half the 46 percent provided in the statutes.

The Senate Finance Committee proposal 2-4-7-10 would reduce the effective tax rate to 13 percent and the President's proposal would propose a negative tax rate of 7 percent.

Now, you might well ask, how could this happen? How could you possibly have a negative effective tax rate? Well, just bear in mind, that if we have immediate expensing of capital outlays that would produce a zero tax rate. If we look at the five year class in the 10-5-3 proposal, we would find that the capital consumption is worth 85 cents and the investment tax credit is worth another 20 cents which produces $1.05.

In fact, the President's proposal is better than expensing.

Well, I don't need to tell you about the effect of negative tax rates. It would be a guarantee that we would acquire capital stock in this country that would be an international white elephant and that is in fact unfortunately, the likely consequences of the 10-5-3 proposal.

Thank you.

Senator HENRY [acting chairman] presiding. Thank you, Mr. Jorgenson. Mr. Strichman.

OPENING REMARKS OF GEORGE A. STRICHMAN, CHAIRMAN OF THE BOARD, COLT INDUSTRIES, INC.

Mr. STRICHMAN. Mr. Chairman, I am chairman of the board of Colt Industries and I appreciate the opportunity to meet with you today on behalf of the Committee for Effective Capital Recovery.

I serve as chairman of this committee which is a voluntary coalition of 549 business firms and 54 business trade associations. The committee is representative of virtually all segments of American business and industry including manufacturing, retail, oil and minerals, transportation and utilities.

The Committee for Effective Capital Recovery is convinced of the urgent need for improved tax treatment for plant and equipment expenditures as a means to help the Nation's economy and help restore competitiveness of American industry in the world marketplace.

In particular, I am here today to urge support for the President's accelerated cost recovery system. No one in this room today needs to be reminded that in recent years the United States has fallen behind most Western nations in productivity.

Fewer issues have received more attention across all strata of our society in the past few months. The drop in productivity has fueled inflation and been a major cause of our loss of strength versus competitors of other nations.

It is our belief that one of the major causes of these urgent national problems has been the lack of adequate capital investment in new plant and equipment.

The reasons for this lack of adequate new plant and equipment investment fall roughly into two categories. One of course, is inflation itself. The other has been the inability of business and industry to accumulate adequate capital.

Three current proposals address and would provide a remedy to this situation. The President's accelerated cost recovery system as well as two members of this committee, Senator Heinz' Capital Cost Recovery Act, and Senator Bentsen's simplified cost recovery system.

The House proposal for the first year capital cost recovery system while aimed at helping solve this problem, really only addresses the effects of inflation and depreciation allowances. In fact, FYCR would adversely affect investment in plant and equipment at a time when it is essential that new investments must be made.

In this regard, FYCR would decrease investments, at least temporarily and in the long run provide—incentive for investment in new equipment than is provided under CCRA and ACRS.

In the past, recovery allowances provided to business have been the primary source of funds to invest in new plants and equipments. Now in order to encourage the greater investment that can result in greater productivity, we must improve these recovery allowances.

We believe the President's proposed accelerated cost recovery system provides the best method of achieving that goal, the best that is, with one modification. We urge this committee to study and compare its provisions of flexibility and commencement of the recovery period with the cost planning provisions of the Jones-Conable 10-5-3 proposal.

It is our opinion on the whole that the rules provided under Jones-Conable are more appropriate and consistent with the ultimate objective of improving capital recovery. To invest in plants and equipments, to improve capital recovery comes in part from accelerated depreciation and partly from investment tax credits.

Flexibility in the way accelerated cost recovery is structured permits each business to recover its investment at a rate more advantageous to its operations and it also avoids the potential loss

of recovery deductions which may occur under any or all carryover rules.

Our committee also urges that the placed and service rule for the commencement of the recovery period should be dropped in favor of the rule which allows recovery to begin when the first actual payment occurs.

The reason for this we believe goes right back to the objective of these proposals. To provide improved capital recovery. In this regard the data assets are placed in service becomes irrelevant in computing recovery deduction.

Finally, we believe that depreciation changes in these proposals should be effective retroactive in January 1, 1981. In the House Chairman Rostenkowski and Mr. Conable support an effective date for any depreciation changes no later than March 11, 1981. However commendable that position is, businesses made investments between January 1, 1981 and March 11, relying on the effective date contained in the various cost recovery proposals being considered.

In the interest of equity and fairness it seems more appropriate to make those depreciation changes effective January 1st.

Thank you very much for the opportunity to appear before you today.

Senator HEINZ. Mr. Strichman, thank you very much.

Mr. Raboy.

OPENING REMARKS OF DAVID G. RABOY, DIRECTOR OF RESEARCH FOR THE INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. RABOY. I am pleased to testify today on the subject of tax neutrality and its relationship to depreciation policy. My name is David Raboy and I am the director of research for the Institute for Research on the Economics of Taxation. I have filed a written statement with the committee and will summarize the contents of that statement here.

It is a widely shared view that there is a need to reform the rules by which businesses recover their capital costs. Excessive marginal tax rates on the income from physical capital have resulted in inadequate rates of investment.

It is recognized that acceleration of depreciation beyond present law will decrease the marginal rate of tax on income from capital services and thus will lead to increased investment. If this was the only problem, however, our goals could be achieved merely by lowering tax rates.

There is another equally serious problem which is specific to depreciation policy. Under present law there is a built-in bias against investment in durable assets. That is, the Tax Code skews investment towards laundramats and penny arcades and away from steel mills.

Therefore, a second goal of depreciation reform must be to move to a neutral capital recovery system.

What is neutrality and why is it important? The basic philosophy behind this testimony is that the tax system should raise revenues for legitimate government activities and not attempt to direct forces in the economy. Resources should be allocated by the free market.

The word "neutrality" implies the situation where economic decisions are made irrespective of the Tax Code. In the case of depreciation the decision to invest in one type of capital instead of another ought to occur, to the greatest extent possible, as if there were no taxes at all.

This is important, because a neutral system will result in the most efficient allocation of capital. Stated simply, a system which is not neutral wastes resources because inputs are used inefficiently.

One of the only existing free lunches can be obtained by switching to a neutral system and gaining output from the same amount of resources. Moving to a neutral system will lead to productivity growth and will relieve inflationary pressures.

The two cost recovery proposals I will discuss are based on entirely different concepts. The accelerated cost recovery system is based on the expensing or immediate writeoff concept and the first year cost recovery system is based on economic depreciation. Proponents of both systems claim that they are neutral.

On the basis of my research, I have concluded that any system based on the useful life or economic depreciation concept is decidedly nonneutral and contains an inherent bias against long-lived assets.

Under the FYCR program, any time the tax rate changed capital composition would shift. A tax rate increase would increase the cost to the investor of investing in a durable asset relative to investing in a less durable asset and as a result we would end up with relatively less long-lived assets.

At any positive rate of tax, there would be too many short-lived assets relative to long-lived. One should immediately question the neturality of a system under which the composition and cost of resources change every time the statutory tax rate changes.

I cannot speak for Professor Jorgenson but Professor Auerbach concedes that this would be the result of FYCR. This was made apparent in a debate between Auerbach and myself that was published in a recent issue of the journal Tax Notes.

Auerbach, however, feels that such shifting is appropriate. If real economic conditions change then changes in costs and composition are warranted. However, if these changes occur solely because of a change in the Tax Code then they are totally inappropriate. If the intuition on this is not sufficient, it should be noted that the theoretical literature on efficiency would support the contention that FYCR is non-neutral and a discussion of this is contained in my statement.

On the other hand, a system which approaches expensing would not distort the costs facing investors and would, therefore, be neutral. ACRS, as the numerical in examples in my statement show, approximates expensing.

Charges that ACRS would result in substantially negative tax rates are based on faulty, and theoretically unjustifiable economic assumptions. In the real world, ACRS passes the neutrality criterion, whereas FYCR would fail even in the theoretical world.

Further, ACRS has ease of administration to recommend it, while FYCR would be an administrative nightmare. Attempting to

measure economic depreciation to the tolerances required for public policy would resemble a dog chasing its own tail.

Because the measurement of economic depreciation is based on used asset prices, which depend on existing tax treatment, any time the Tax Code changed the data on which FYCR was based would immediately be obsolete.

Further, under FYCR the realtive benefit positions of certain classes of assets would be reversed, and the IRS controversies would be enormous.

Thank you.

Senator HEINZ. Thank you, Mr. Raboy.

Professor Jorgenson, I don't want you to feel that after that statement I am picking on you as well, but I do have a question about the first year capital cost recovery method. If you would have to determine the future economic depreciation why at a discount rate as I understand your proposal.

Dr. JORGENSON. That's right.

Senator HEINZ. How are you going to set that discount rate. How do you determine it?

Dr. JORGENSON. You determine it by looking at the vast experience we have had in the post-war period over seven business cycles now, which shows conclusively that the after tax, after inflation rate of return has been very, very close to constant at about 6 percent. This is a finding that Mr. Raboy refers to in his testimony and in his Tax Notes article and is something that is corroborated in my own research and that of Holland and Meyers, two economists at MIT. It is generally accepted finding, so there is no problem about determining the rate of return. It's an empirical fact and has, in fact, been determined.

Senator HEINZ. Do you believe that that particular measure, the after-tax rate of return is the right one?

Dr. JORGENSON. Yes, the after-tax rate of return is the right one because it of the fact——

Senator HEINZ. Why not support tax rate of return or why not something that takes into account the depreciation upon the inflation?

Dr. JORGENSON. Well, it is really simple, Senator. We are discounting after tax streams. In other words, we are looking at a tax base which represents the income of the taxpayer, reduced by its deductions and then we apply the tax rate to that, and discount that.

Now, since we're discounting an after-tax stream, we have to use an antitax discount rate.

Senator HEINZ. A question for, I suppose all of you. Dr. Thurow this morning advocated a very simple way of achieving neutrality. He advocated getting rid of corporate tax rates or reducing them significantly with no depreciation reform. What do you think of this side? Let me start with Mr. Raboy and work back up to Professor Jorgenson.

Mr. RABOY. Well, as I said in my statement, there are two problems, here. First there are unacceptable levels of investment due to excessively high tax rates. Even if you were to drop the rates though, you would also have this bias against long-lived

assets that we have in the Tax Code. And, as long as you kept the present depreciation system, that would be perpetuated.

Senator HEINZ. Why would you have a bias, if there are no corporate taxes.

Mr. RABOY. Well, if there were no corporate taxes at all—if you eliminated the corporate taxes completely, obviously that would be a neutral system because there would be no tax. I am an economist not a politician. I am under the understanding that that might not be politically palpable at this time.

Senator HEINZ. Well, we are certainly on even grounds because I am a politician, but not economist. [Laughter.]

It seems to me an equally unequal combat.

Mr. RABOY. As an economist, I would support repeal of the corporate tax.

Mr. STRICHMAN. If you are really talking Senator about getting rid of corporate income taxes, all I can say is hallelujah. And let's stop all the rest of the discussion.

Senator HEINZ. Don't let your enthusiasm get carried away. Of course, they have managed to do this in Europe. They really have—many countries use the value added tax as a means of taxation.

Mr. STRICHMAN. Right.

Dr. JORGENSON. I would like to respond to that. I think it is a question of whether you want to use the revenue as was suggested a moment ago. If you are really out to eliminate the corporate tax, you're talking about foregoing all the revenue, I would say that if you have a more limited objective and a more limited amount of revenue loss, then the argument for adjusting depreciation, in other words adopting the first year system, is an argument that it would affect incentives at the margin where the new investments are made. It would not create a lot of income for people who have capital in place that is not going to be affected by the corporate tax treatment.

So, the idea is if you want to concentrate on incentives and let the market do its work, then you ought to focus the revenue losses that you do take on new investment. You can do that by accelerated depreciation or do it all at once by the first year system.

Senator HEINZ. Professor Jorgenson, thank you. Senator Long.

Senator LONG. Thank you, Mr. Chairman. I am sitting down here because those TV lights are kind of bothering me a little bit. You know by the time you get to the age of 60, you find that your eyes react to those TV lights after while.

Let me just explore this matter with Professor Jorgenson. May I say, Professor, you have made a major contribution to the thinking in this area, and please forgive me for the statement I made earlier today that the first time I heard you explain your views before the committee, I didn't understand what you were talking about. It is very profound, it is like some of these things I see back here in your statement where you have some of these complicated equations which I don't understand, but I'll try to adjust.

Now, the panel I interrogated this morning had some very prestigous witnesses too, Mr. Charls Walker and Mr. Massa speaking on behalf of the American Management Association of Manufacturers. Now for some reason they don't like your approach at all, they call

it first year expensing, in other words first year recovery, but they say that if you are talking about expensing, that's a different matter, and it sounds to me that they would like that better than the 10-5-3.

Now, can you explain to me what the difference is and why you might think that expensing would or would not be better than first year capital recovery.

Dr. JORGENSON. I would be glad to explain that Senator.

As I said in my opening remarks, expensing reduces the effective tax rate to zero and that is why these gentlemen you referred to, Mr. Walker and the president of the NAM regarded that as a step forward.

In fact, I think that if you'll ask my associates here on the right, you will probably find similar sentiments.

However, 10-5-3 is better than expensing, because whereas expensing enables you to write off a dollar for every dollar you invest and that reduces the tax rate to zero, 10-5-3 for the 5-year class that would cover most kinds of equipment results in a $1.05 write-off for every dollar that you invest and therefore, that's better than expensing. So, in effect, the Government pays you to undertake the investment, rather than have you pay it. In other words, it creates a tax shelter. That is the only name for it.

Now, as far as the first year system is concerned, it is possible to design a first year allowance that would produce a zero tax rate and that first year allowance would be a dollar for every dollar. It would be expensing, so that is a possible first year system that would preserve many of the advantages of simplicity and ease of administration of the first year system in general.

If, however, you take account of the other elements in the Tax Code that affect the rate, such as tax deductibility of interest, and expensing of certain development costs, research and development for example, then the only way to get a zero rate for capital as a whole is to have a positive rate on depreciable assets. For that reason, the form in which the first year system has been introduced in the Ways and Means Committee by Jim Shannon and his associates produces a very simple scheme in which you have four classes of assets and first year expensing associated in each one of them. I happen to have those here and they are 98 cents on the dollar for assets with less than a 4-year life under the current system, 97 cents for those from a 4 to 8 year life, 95 cents for those from 8.5 to 14 and everything over 14 basically engines and turbines, 93 cents.

So, that's a very simple system in which you expense the first year allowance. You get that as a deduction. But instead of getting dollar for dollar you get something less than that to reflect the time value of money and the fact that assets with different lives are in fact going to have different rates of economic depreciation.

This particular scheme produces a 15 percent effective tax rate. It keeps a positive rate, preserves the corporate income tax, but has the advantage of neutrality, and as Chairman Rostenkowski never tires of emphasizing and Mr. Raboy also emphasized, neutrality is absolutely central to these discussions because what we are talking about is not investing as such, we are talking about enhancing productivity. The only way to insure that every dollar of

investment enhances productivity to the maximum extent, is to make sure that the effective tax rates are the same for all assets.

Unfortunately current law doesn't do that, 10-5-3 doesn't do that, but the first year system does and so does expensing. In that respect the two systems are very similar to each other and have a lot of the same advantages from the administrative point of view.

Senator LONG. Let me just say this now.

I believe that we ought to have a minimum tax. I was here when they passed the first minimum tax. I regret to say, we hadn't done a very good job, and I find myself saying that we ought to try it again, get the best advice we can, but the minimum tax should not be an add-on tax, it should be an alternative tax.

Thinking in terms of what the alternative tax should be. I find myself coming down on a 15-percent figure. Now the reason I do is because I am going to propose that we have two things since nobody else proposed it.

One, we get the tax on investment income down to 50 percent, stop the discrimination against investment—do you agree with that.

Dr. JORGENSON. I certainly do. I am a great supporter of this proposal and I think that is a great idea.

Senator LONG. Well, then, so we're together.

All right, No. 2. We have voted some time back, 1978 I believe it was, and the Senate voted almost 90 percent in favor at that time, to say that we would not tax the first 70 percent of a long-term gain, but only the remaining 30 percent. Now 50 percent times 30 percent would be 15 percent.

Dr. JORGENSON. Exactly.

Senator LONG. Now, that recognizes the fact that in many cases what you are taxing with a capital gain is purely illusory income but if I say this compared to what the situation is now, the business community will applaud for that.

How do I know? I have tried it on them. They have given me a big hand. They love the idea. Now, it would seem to me that if it is fair enough to say that in any event you should pay some taxes, then 15 percent should be about fair.

Now, if you do that type of thing, it would seem to me that we would be coming down about where you are advocating.

Dr. JORGENSON. That is exactly where we are Senator. That is exactly the effective tax rate in bill 3443 that has been introduced on the House side.

Senator LONG. When we first came out with the investment tax credit, that was my amendment that said that you couldn't depreciate something you didn't pay for to begin with.

It was originally a 7-percent investment tax credit, and I put an amendment on that said you could only depreciate the part that was left after you got the subsidy. Later on I was finally persuaded by John F. Kennedy and others to go along with them and allow depreciation of the 7 percent. But I do feel that people ought to pay some taxes, and I don't believe that anybody who makes a fight to fix it up so that people who make a ton of money pay no taxes is going to make out very well at the polls. I just don't think you can defend that very well.

I know a lot of people think that millionaires don't pay any taxes, and some may be getting away with that, but I honestly think that as far as the majority of this committee is concerned, up to this stage, we have never been willing to knowingly permit a situation where very wealthy people could make a lot of money and not pay any tax.

Dr. JORGENSON. Well, 10-5-3 is the scheme for it. Turning the whole of a new investment into a tax shelter and that is exactly what it is going to do, Senator. These rich people are going to adopt these leasing schemes that were discussed in the panel before us and by that means translate these benefits which they may not be able to avail themselves of in the case of Chrysler or Ford directly to rich taxpayers. Now I have nothing against rich taxpayers, I am just saying as you do that they ought to be paying tax.

With 10-5-3, those benefits, in the form of leasing schemes are going to provide them with money subsidized by the Government that they can write off against their other income, whether that income is generated to entertainment, in professional practice, or in productive investment, and so the unintended consequence of the 10-5-3 scheme is going to be to benefit these people by enabling them to buy all this tax shelter and essentially eliminate the taxes that they are now paying.

Senator LONG. Let me ask the other two witnesses about this. I have talked to Mr. Strichman down through the years, and may I say that usually it is easier for me to understand his testimony than yours, but I don't know if we are going to agree here. What do you think, Mr. Strichman, about the idea of making a ton of money and not paying any tax?

Mr. STRICHMAN. Well, now you are talking about—I thought we were talking about 10-5-3. I certainly would agree with you because 10-5-3 has nothing to do with what we were just talking about. You are saying about individuals, I think you talked about an alternative minimum tax. You realize that is not what we have now. What we have is a tax added on to a tax. I think if you came up with an honest to God alternative minimum tax it would make a lot more sense and could be more easily used by everybody in this country, but it has nothing to do with 10-5-3 and I am here to speak about that.

I want to say something about that though, because I had the impression from Professor Jorgenson and I think everybody here has the impression that 10-5-3 ends up in taking away income taxes from companies. Now I want to tell you exactly what it does.

I had Arthur Andersen, a good CPA, figure out our 1980 return with ADR exactly as it is, and with 10-5-3 and here is the way it came out. We paid last year about I can only talk about Colt Industries, because that is the only one I know, but we paid last year about $139 million worth of all kinds of taxes—payroll, property, Federal, excise, sales and miscellaneous, right on down, of which about $71 million was Federal income tax.

What happened with 10-5-3 in full effect as calculated by ourselves and having a writing from Arthur Andersen, they agree was our depreciation went up from $50 million to $70 million, our net income tax paid dropped by $9½ million and that is a hell of a long way away from paying no tax, we went from $71 million down $9.5

million. And on all taxes totally paid we went from the $138 million down to $129 million. Now, that is still paying an awful lot of tax and it does not have the effect that Professor Jorgenson is indicating. The real truth of the matter is that you pay one tremendous amount of tax and the effect of 10-5-3 is exactly what it is supposed to be, to supply some more cash to buy some more equipment with.

Dr. JORGENSON. I agree with everything you said. I don't disagree at all. That's exactly right.

Senator LONG. Hold on a minute, and I'll come back when my turns comes but I would like to get Mr. Raboy—what do you think about the idea that people ought to pay some tax. They shouldn't get by without paying anything.

Mr. RABOY. I think that is true. What I would like to talk about is this concept of effective rates that Professor Jorgenson has been talking about.

An effective rate as defined by Professor Jorgenson has no relationship to what we usually constitute as an effective rate which is the ratio of tax liabilities to your income. Now about expensing producing a zero effective rate: In a pure economic world all that says is that you would get a deduction in the first year equal to the price of the asset, and if you discounted all the tax payments you paid ad infinitum, they would be equal to the deduction. That doesn't mean that there are no checks going to the Treasury, what it means in the pure theoretical world it is sort of like the Treasury being a partner in the investment and they get the same rate of return as the investor does.

Now we don't live in a purely theoretical world, we don't have perfect competition in this world and there are also some market imperfections and as a result I would suspect that there will be a significant amount of money still flowing through the Treasury even if 10-5-3 goes into effect.

Another point I would like to make about these effective rates, Professor Jorgenson keeps talking about and, again, I am going to use his definition of effective rates, concerns his claim that if all firms have the same effective rates that resources will be allocated efficiently. Well, I went back to my old microeconomics textbooks and I went back into the old journals and I tried to find a reference to some statement that said that this was true. And I couldn't find that. But what I could find was the statement that if you got a bunch of different capital types out there, and you are thinking of putting a dollar into one of them or the other, what ought to happen is that the incremental output from each asset that you might consider investing in ought to be the same.

If I have a dollar here and this asset is going to produce more than this asset, well I am going to put my dollar there. If you read Professor Jorgenson's papers from 1967 he will tell you that a firm will purchase assets up to the point where the price they have to pay for this asset exactly equals the contribution that this asset is going to make and I agree with that. I have read these papers.

Now, in my analysis I show, that under his system, the tax rates would distort these prices. So, if you started out in a situation that was efficient, where all capital types were producing about the same kind of output and resources were used efficiently and you

put into effect his situation then that is no longer going to be true. This asset might be producing more than this one which might be producing more than this one, and what you have is inefficiency in the economy.

Senator LONG. Well, I have more than used my time, and I'll come back if I have an opportunity and I want to explore this matter further because I think all of you have some very profound—I would like to know more about it.

Senator Symms [acting chairman] presiding.

Thank you very much, Senator Long.

Mr. Raboy and maybe Professor Jorgenson, this is directed to you also, but don't we all agree that what we want is equity in the tax system.

Mr. RABOY. We certainly do.

Dr. JORGENSON. Yes.

Mr. STRICHMAN. Yes.

Senator SYMMS. Isn't the depreciation—accelerated depreciation schedule 10-5-3 more equitable than your first-year cost recovery.

Dr. JORGENSON. No, it is not because under 10-5-3 the effective tax rates on different assets and therefore for different taxpayers who hold these assets would differ. For example, if you look at the inflation rates that were prevailing in 1980, you can find that under current law there is a gap just between structures in general and equipment in general of 18 percent.

Under 10-5-3 that gap which represents lack of equity increases up to a level of 36 percent. In other words, we roughly double the inequities that are in the current law. So 10-5-3 is a much less equitable system than current law. Under this first year capital recovery system, there wouldn't be any gaps like that. All assets would have the same effective tax rates, and that is the condition for equity.

Senator SYMMS. Well, I'll let you comment on it. I just want to make another comment. Don't you think we ought to have the market make that determination rather than the Tax Code.

Dr. JORGENSON. No, because there are limits to what the market can do, Senator Symms. For example, if we wanted to collect revenue, then we would have to have tax rates that are positive in the code. We can't actually let the market determine what the tax rates are going to be.

Senator SYMMS. Well, isn't it true that in the first year cost recovery, that we will actually interfere with the choice that a businessman will make between long and short term assets.

Dr. JORGENSON. No; it will make the choice that a businessman will make between long-term and short-term assets a choice that is effected only by economic considerations and not by tax shelter considerations, because it will insure that long-lived and short-lived assets will have exactly the same tax burden and, therefore, will be treated equitably under the Tax Code.

Senator SYMMS. David Raboy; would you want to comment on that?

Mr. RABOY. Yes; it seems to me that if a tax system is not going to effect economic decisionmaking then it ought not distort the costs facing the economic decisionmaker.

Dr. JORGENSON. No; that's wrong. You have said that before and that is not correct. That is not the generally accepted differential——

Mr. RABOY. Well, I am going to have to go back to microtheory.

Mr. JORGENSON. You certainly will. In fact, I'll tell you what. Here are some references for you.

Mr. RABOY. I brought them Professor Jorgenson.

Dr. JORGENSON. On page 89, footnote 5, I refer to the literature that you apparently missed. Combinations of expensing and economic depreciation are analyzed and here are three references, you can go look them up in the library.

Alan Auerbach, 1979, Journal of Political Economy. That is something that you can subscribe to. In fact, I do. You can look at Arnold Harburger's article in 1980. This is published in a volume that was published here in Washington. The Brookings Institution. I could go down and buy a copy, and there is a paper by David Bradford who was formerly Deputy Assistant Secretary of the Treasury on this same point.

Senator SYMMS. Dr. Jorgenson, let's let him comment on it. I appreciate your enthusiasm, but——

Mr. RABOY. While we are compiling a bibliography, there is also an Under Secretary of Treasury and also there is an article by a guy named Robin Broadway in the Economic Journal.

But, the point is, economists disagree. I don't think that is a surprise to anybody here. [Laughter.]

Mr. RABOY. I will maintain again that if you distort the relative costs facing investors in the decisionmaking process, that that is inefficient.

But, I want to point out one other thing. Professor Jorgenson says that economic depreciation creates this neutral situation, and if that's true, according to a statement by him, under present law circumstances we have the proper allocation of resources.

I want to quote from the paper where that nice bibliography came from and I quote "we find that present U.S. tax law provides capital consumption allowances for corporate investment as a whole that are in line with economic depreciation at currently anticipated rates of inflation."

Senator LONG. May I just make a point here.

Let me urge these economists to try to discuss this thing in terms that we noneconomists understand, because I know you fellows are not going to convince one another, but you might convince one of us. [Laughter.]

[Senator Heinz is back.]

Mr. STRICHMAN. Senator Symms gave me a chance, and Senator Long I have to say something to you, because we have had a lot of dialog in the last 10 years. I remember one time you looked at me and you said, "Strichman, I may not know much, but what I know, I know very well."

I want to tell you something, Senator Symms, I have never heard so much discussion that is so far off the point as I hear right now. I have Professor Jorgenson telling me how businessmen make decisions, and I am going to tell you something, I can't believe what I am hearing.

The real problem is not up for discussion. The problem is, this country is losing its productivity at an increasingly rapid rate because, unlike the other countries of the world, against which we must trade and compete, we do not have modern up-to-date equipment because we have the lowest savings rate in the world of industrial countries, and we have the lowest investment as a result.

What we have to discuss here today is changing that, and the whole point of the capital recovery system is to augment our current capital recovery so that we have more savings and more investment and all of this other stuff is sheer nonsense.

We have, it is, believe me, and when somebody tells me the short term, the long term, let me tell you what you put it your money into, if you are running a business. You put it into what you need. You put it into the things that are necessary to make it possible for you to compete not only in the United States, but around the world. And that decision has nothing to do with all of this that we are talking about.

It has to do with Professor Jorgenson, who has gotten useful lives back into this. That is the whole point of 10-5-3, to get away from it. What is a useful life? Is it because a machine will last 20 years and say you are going to use it for 20 years? No way. Is it the economic life? What is the economic life?

Let me tell you something, Senator. When you buy a brand new computer, it is almost obsolete the day you buy it, and the thing that really determines the useful life is when somebody else is buying machines that put you out of business, because they do it twice as fast as the machines you have, and that is not in this anyplace.

All this is nonsense, and the whole 10-5-3 concept is to get away from useful lives, to augment capital recovery so there will be more capital recovery and allow more capital to go back into business to buy the things that each business knows it needs any way it figures it out.

Senator SYMMS. Thank you very much.

Mr. STRICHMAN. Thank you, Mr. Chairman.

Senator HEINZ [acting chairman presiding]. Senator Symms, Senator Baucus, I believe you came in or did Senator Bentsen come in before Senator Baucus? Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Chairman. Dr. Jorgenson, I've told you this before, I am going to tell you one more time. I heard you before the Joint Economic Committee here to. You would really help us if you would give us a summary of what you are about to speak on, so that we can follow it and read it as you do it.

I think you would make a major contribution. You have come up with a new idea that we have to think through, but you would find that this committee would follow you a lot better if you would do that.

Now, Mr. Strichman, let me talk to you a little about this real world you are talking about.

We talk about 10-5-3. Then we talk about 2-4-7-10 or some variation. Under 2-4-7-10 we set up a basket for each of these and this is not some new idea, this is something the Canadians have been proving to us, and we gave you flexibility from 200 percent to

150 percent to a straight line, and amongst the different baskets. That's a great deal of flexibility.

Now the other thing that concerns me about 10-5-3 other than not having as much neutrality in the treatment of the equipment, and I think 2-4-7-10 can be improved from that standpoint, but what concerns me is phasing it in over 4 or 5 years rather than putting it all in at once.

I agree with you, we have go to step up that cash flow, so that you have the availability of the capital to buy that new equipment to start rebuilding this country of ours. But I am concerned that business will say, well, next year is going to be a little better as far as the depreciation schedule, and then when that comes around, they will say next year is going to be a little better. We can put it off.

There will be some of those marginal decisions that will be influenced by that. Not the major ones where you have a competitor that has come up with a major new piece of equipment, you have got to go regardless.

Whereas, if we go 2-4-7-10 or something similar to that, we put it all in at once and we cut back from the three 10's so we have room to do it. Maybe we we will talk about three fives or three sixes or three sevens, but that we dramatically change the depreciation schedule all at once so that in the board room and in management across this country, they say, you know, that bunch down there in Washington has finally done something about depreciation. We ought to be rethinking some of our capital commitments.

I really believe this tax package ought to have room for the depreciation schedule to be not phased in, but put in all at once.

I feel the same thing about the capital gains. We ought to come from the 70 to the 50 and then turn to the capital gains, not phased in, but all at once and I think we will have much more impact than with what we do to try to start the increasing of productivity in our country.

Would you comment on that.

Mr. STRICHMAN. Senator Bentsen, I like what you are saying. I don't really know the difference in cost of 2-4-7-10 versus 10-5-3, so I am not in any position to make a comment on it, but I will tell you this: You are right on the track. We have already lost a couple years since 1979 when 10-5-3 started and we really ought to talk about phasing it in in 3 years instead of 5 years.

If the Treasury can stand the cost of phasing it in all at once, I am with you 100 percent. The only reason it is being phased in in 5 years, is because everybody said we can't take the cost.

But, certainly if we could put all in in 1 year, I'm with you.

Senator BENTSEN. Well, I don't think you can take the cost, unless you go back to say, three fives, three sixs or three sevens, then that gives you some room to do it.

Now, 10-5-3 in the long run will cost more and give more to business. In the long run 2-4-7-10 is not that expensive. It increases the depreciation schedule by a minimum of 50 percent, a minimum of 50 percent.

Senator HEINZ. Senator Bentsen, thank you very much. Senator Baucus.

Senator BAUCUS. I am just curious whether you agree with Dr. Jorgenson on one point, I know you don't on many. One point he makes is a little provocative, therefore, you probably disagree. His point is that a fully implemented 10-5-3, 3-year and a 5-year category tends to subsidize capital. Do either of you agree with that?

Mr. RABOY. The way you get to the position that the 5-year category subsidizes capital is, OK, these depreciation deductions are spread over a few years, and somehow you have got to represent them as if you were taking a whole bunch in the first year. You have got to value it somehow. You have got to discount your deductions, and in order to discount your deductions, you have got to come up with a discount rate, and economists will argue ad nauseum over what constitutes a proper discount rate.

A discount rate should represent what you are giving up by investing in a certain type of asset, so there ought to be a provision the rate of return you could get elsewhere, but since depreciation deductions are set by statute and are eroded by inflation, you have to make a guess at how much those deductions would be eroded in outyears.

So, you have got to come up with something that represents your expectation as to what is going to happen with inflation.

I did some calculations also, and I used what I consider to be a lower bound on inflation, and at current rates of inflation or actually slightly less than current rates of inflation the 5-year category just about exactly equals expensing.

I would say that if you get——

Senator BAUCUS. That's also at current interest rates.

Mr. RABOY. Yes, I am using Professor Jorgenson's representation of an after tax rate of return and so——

Senator BAUCUS. What rates are you using?

Mr. RABOY. About 19 percent.

Senator BAUCUS. Nineteen percent, and that's the pretax interest rate, is that right?

Mr. RABOY. It is an after tax rate of return plus what you think is going to happen to inflation in the future, your expectations as to what's going to happen to inflation.

And, again, this is guess work. We have pulled these things from the sky as Professor Jorgenson pulls them from the sky, as everybody does—you're making a guess.

I tell you what, if inflation rate comes down to about 6 or 7 percent I will come here and testify before this committee and say we ought to eliminate a percentage point on the investment tax credit and that will bring the value back down.

Senator BAUCUS. I am trying to determine whether you think 10-5-3 is subsidizing.

Mr. RABOY. Oh, OK. What I am saying is my calculations show that it just about—the 5-year category just about equals expensing and therefore it does not subsidize capital. You would have to get inflation rates down much, much further than they are now. And, of course, the 10-year category, the 15- and the 18-year category have possible——

Senator BAUCUS. Professor Jorgenson, do you have a response to that?

Dr. JORGENSON. Yes, I think if you look at the Reagan economic program, it is predicated on a future inflation rate that is going to be 6 percent within 2 years.

Now, in fact, Senator we had the 6-percent-inflation rate, back in 1976, we had it in 1973, so it is not outside the range of our experience. Mr. Raboy's figures show and I am just recording from his paper here, that for every dollar of investment, you get $1.04 in deductions, to be precise, $1.03.92 in deductions in 1973 inflation rates.

So, if the Reagan program works, Senator, it will turn out that even Mr. Raboy with the wildest kind of assumptions about the discount rate, will produce the conclusion that 10-5-3 subsidizes investment. It's right here on this paper.

Senator BAUCUS. Mr. Raboy, do you have a response to that.

Mr. RABOY. Again——

Senator BAUCUS. Do your figures show that 1983——

Mr. RABOY. There is a couple of footnotes down there. What we did was we made sure we used everything—the discount rate as low as we thought possible——

Senator BAUCUS. But, if we have inflation rates in 1983 at 6 percent, then do you agree that a 5-year category would be subsidized?

Mr. RABOY. Yes, then it would be. My suggestion therefore, is that I feel that the ACRS program is very good and if we get down there, and the way to go about it is to maybe remove a point on the investment tax credit rather than scrapping the whole thing and putting in something that would be very distortionary.

Senator BAUCUS. What is your analysis on the effective tax rates of 10-5-3? What is in your judgment, the effective tax rate given your stated economic assumptions on, say, inflation?

You still have about 30 seconds.

Mr. RABOY. Again, this is Professor Jorgenson's definition of effective tax rates. On the 5-year category it would be zero, on the 10-, 15-, and 18-year categories, it would be significantly higher, I don't have numbers on that.

Senator BAUCUS. Thank you.

Mr. STRICHMAN. May I kind of answer that question——

Senator HEINZ. Please proceed.

Mr. STRICHMAN. Again, I have a hard time listening to the discussion whether its $1.05 or a $1.04 or a $1.03. Right now, who cares. You spend $100,000 for a piece of equipment, and you replace it 5 years later because it is obsolete and now it costs you $250,000 and all you depreciated was $100,000 and that's the real world again.

Senator BAUCUS. I think that is probably correct too, but I think that underneath all of this discussion, what we're really trying to decide is how much we're going to help stimulate savings and investment. What terms of aggregates amounts? A lot of the discussion around 10-5-3, first year cost recovery, and 2-4-7-10 is basically a discussion of how much we can afford during each of these years—correct?

Mr. STRICHMAN. That is it. And the answer is as much as you can afford is what we need, it will not be enough.

Senator BAUCUS. Well, from one perspective, I'm sure that's true. The trouble is that we here have to balance needy perspectives. Different people have different needs and different desires, different wishes, we have to try to strike——

Mr. STRICHMAN. True Senator, but you have to remember, there are a lot of words going around the House and around the Senate that say we have to increase productivity. Now how in the world do you think you are going to do. Go out and kick the worker.

The only way that is available to us—you know the American way is that everybody does a little less work every year for a little more money, that does not increase productivity. The only way to increase it is by investing in plant and equipment that use less hours to turn out the same thing as they are doing now and that costs cash and what we are limited is by the amount of cash we have. It is as simple as that.

Senator BAUCUS. I know. Everybody talks about increased productivity. I grant you everyone does. I don't know anybody who is not in favor of that. But everyone is also in favor of increasing the defense budget and in favor of a lot of other things that we have just got to find the money to pay for. That's part of the problem.

Mr. STRICHMAN. Thank you very much.

Senator Heinz. Gentlemen, I have one question. You talked about how there might be a windfall under 10-5-3, that a 10-percent tax credit combined with accelerated depreciation may be more generous than expesnsive.

Why, if that's the case, shouldn't we simply phase in the expensing of class 3 and class 5 property to avoid that problem?

Dr. JORGENSON. In other words you are proposing phasing in total expensing.

Senator HEINZ. Well, why not. You are saying is that 10-5-3 is more generous than expensing.

Dr. JORGENSON. Yes; exactly.

Senator HEINZ. So, if it's better than expensing why not phase in expensing.

Dr. JORGENSON. Well, I think you are right and I think from a political point of view, this is a——

Senator HEINZ. Now, before you agree with me, let's think the argument through. What that has to mean then, is that expensing class 3 and class 5 properly would be cheaper for the Treasury than 10-5-3 provided it was phased in.

Dr. JORGENSON. Exactly. Expensing would be less costly than 10-5-3. Phased in expensing would be less costly. That's right.

Senator HEINZ. Well, is there any reason then, why we shouldn't do it.

Dr. JORGENSON. Simply that we need an income tax. If it were the case that there were no other provisions in the income tax that effected deductions, for example, there were no other deductions, there was no expensing of research and development, there was no tax deductibility of interest, then there might very well be an argument for saying let's shift to a system in which we have total expensing.

But, in fact, there are these other provisions that provide other sources of tax deductions, and the only way to get around that is to have the kind of thing that Senator Long suggested a moment ago.

Namely, a minimum tax say around 15 percent and that is what is provided by the first year capital recovery system.

Furthermore, that 15 percent is something that is not affected by the rate of inflation. You recall, Senator, a momement ago that Mr. Raboy admitted that 10-5-3 reduces subsidies to investment at a 6-percent rate of inflation. Ask him the following question, or maybe I should ask him. What exactly would we have in the way of a subsidy if we got back to zero, suppose we had no inflation. We would have a negative tax rate up in the 30's.

So, that's the basic defect with 10-5-3. You can't have increases in productivity resulting from investment if you are going to dissipate the capital on unproductive tax shelters.

Senator HEINZ. Let's not get too far ahead of the argument here, if you don't mind. My question to you is, how can you maintain that both expensing and 10-5-3 will create subsidies. It would seem to me that 10-5-3 since you claim it costs more, will lower taxes more than expensing. Maybe, I misunderstood your point.

Dr. JORGENSON. Well, no; my point was that the objective is not to eliminate taxes, the objective is to stimulate productivity, in other words, to make sure that every investment dollar yields the maximum return in terms of productivity.

Senator HEINZ. Well, on that point, do you think the phasing of expensing of class 3 and class 5 property over a 5-year period would do a better job of stimulating productivity than 10-5-3.

Dr. JORGENSON. Expensing would be better than 10-5-3; 10-5-3 provides subsidies and expensing doesn't. So, in that sense it would be better because it wouldn't waste investment dollars on tax shelters.

Senator HEINZ. Let me share the wealth of this discussion with our other panelists.

Mr. STRICHMAN. With regard to what you just asked, as long as you don't drop the investment tax credit, let's go to full expensing tomorrow.

Senator HEINZ. But, you wouldn't get the investment tax credit——

Mr. STRICHMAN. Why not, we have already proved what it does for the economy. Everytime you put it on the economy goes up and you collect more taxes. Ask Senator Long, he's got the charts. That was proved in what happened in this country, you know, it was on, it was off, it was on, it was off, and every time when the Treasury Department said your revenues will be down, they went up and when they said the would go up, they went down. That investment tax credit is an incentive, it is not depreciation.

Senator HEINZ. I assume we were not speaking about expensing while also retaining the tax credit. Now, which would you prefer. The 5 and 3 classes treated as proposed under my bill and the administration bill which includes a tax credit or phased in expensing without the tax credit.

Mr. STRICHMAN. The 5 and 3 with the ITC.

Senator HEINZ. All right. I assume you agree.

Mr. RABOY. Actually, I am not sure I do. If this Committee were to offer immediate expensing as an alternative, I would say fine and let's go home.

In the real world, I guess there was some hesitancy about such a thing and I think that's where the 10-5-3 proposal came out of.

All this talk about subsidies. Well, if I am a manufacturer out there, I doubt if I am going to put my machinery out in a field without any building over it and so you can't just look at the 5 year category. You have to take into consideration, that there are some longer categories involved in the program and that people use machines and they put buildings over them and sometimes these buildings would have to be depreciated over 10 years. When you look at the whole picture then in pragmatic terms, 10-5-3 would not exceed expensing.

But, to answer your question one more time. Yes, I would favor immediate expensing with the phasein.

Senator HEINZ. If there are no more questions, Senator Long.

Senator LONG. Could I participate a little more in this.

First, I want to say this. Mr. Strichman reminds me of earlier hearings. I was around here on this committee before anybody else—I hate to admit I have been around here that long. I was chairman of the committee before a single Republican member if my memory here serves me, and I recall some of the things that happened some years ago.

Have made the point in this room that when we put the investment tax credit in, we assumed it was going to cost us a lot of money. Instead, the record shows that instead of losing money, it made us money. I see Mr. Strichman nodding, because he recalls this, and we discussed it and it proved out.

Then we thought the credit was overheating the economy, so I was one of those that said let's get rid of it, it's overheating the economy and it's causing us to pay high interest rates, and so forth.

Now, mind you, this was back in the time that we didn't have much inflation. So we sold the administration on getting rid of it, and they got rid of it.

Instead of our income going up it went down, and then we said, well, it looks like maybe we better call Congress back for special session to try to help the economy.

So, we put the investment tax right back in again. But again, that's costing you a lot of tax money. So we have put it on again, off again, on again, off again, about five times.

It worked out the same way. The investment tax credit, the last time I saw, was costing $1 billion a point. No such thing is making us about that much.

Senator HEINZ. As the Senator from Louisiana has pointed before, even a blind hog finds an acorn, now and then. [Laughter.]

Senator LONG. I believe that the facts are there to show that when we started making it possible, it was my amendment that said you can't depreciate something that you didn't pay for. I later on relented on that and gave up on it, but on the theory that it looked like a subsidy that was justified.

Now, it may be that the witnesses here don't agree with it or that nobody in the room agrees with it, but I can go back to an earlier date and show you when there was nobody that could argue about it. That's the way that it was working out. So that it doesn't bother this Senator. Just face it as though it was a subsidy.

Incidentally, Senator Kennedy and I don't agree on very many things, but every now and then we do agree on something. I don't know whether that proves it right or wrong, but the two of us joined forces to introduce a bill that would make the investment tax credit refundable. We sent a letter down to the President urging that he consider it. I'm sure he thought that if the two of us were together on it, you better watch it, there had to be something wrong about it.

But, we stated, in representing these two often divergent points of view, that this is a subsidy and if you are going to provide this subsidy, then you ought to provide it to those that need it the most rather than those who need it the least.

But, here's a point I wanted to make to Dr. Jorgenson. Doctor, I don't quite understand this about your point of view.

Now here is Martin Feldstein who also comes from Harvard and he impresses me, just as you do, as a very intelligent man who's done a lot of good research.

We are taxing business a lot more than we intended to tax them. When it comes time to replace a piece of equipment it is costing a great deal more to replace it than we had permitted these people to write off.

Dr. JORGENSON. I agree completely with that. That's exactly right.

Senator LONG. You perhaps read his study where he made that point.

Dr. JORGENSON. I did.

Senator LONG. Now, that being the case, we ought to get to the point to where we are not putting an additional inflation tax on business, and what you call first-year recovery or somebody else calls expensing, still sounds to me like it is a distinction without a difference.

Now, if we say all right, what we are going for would be a first-year expensing or whatever you want to call it, when you buy a piece of equipment if you pay $100 for it, OK, you get a writeoff against $100 of income, and if you are in the 46-percent tax bracket you are still paying $54.

Now, what I don't understand is how do you figure that that is a negative tax.

Dr. JORGENSON. That is not a negative tax Senator. The idea would be that the first-year allowance would enable you to set the tax rate at whatever level you desired. That is the beauty of the first-year system. That you could as it is in the Shannon bill put an effective tax rate of something like 15 percent and make sure that that rate is carried across the whole economy and paid by all new assets.

That is exactly what the bill is intended to do. Now, that is a reduction over the current law. The current law provides an effective tax rate around 25 percent, because of the investment tax credit.

The subsidy offsets the high statutory rate and so what this bill is intended to do is to reduce and provide the incentive that Mr. Strichman has identified here and is needed in our economy for more capital recovery, but it does not create that by means of giving income to existing assets that won't provide any incentive to

accumulate new assets, and that's the difficulty with Mr. Thurow's position as exposed this morning in favor of a recut.

In other words, that doesn't achieve the objective at the minimum cost.

Senator LONG. Well, here is the thought that occurs to me. It may be that you gentlemen can't agree on this, but so far I haven't detected disagreement on the basic points to me that are important. And that is this.

Looking at it from the point of view of someone who is in the oil business, which I understand, since I have lost a lot of money in it from time to time and I have also made some money in it.

[Senator Dole is back.]

Senator LONG. An oilman will go down to the bank to borrow some money. The banker says, well, how much money did you make last year? Do you mind if we look at your tax return? This oilman says, look, it won't do you much good to look at that tax return, because that tax return is going to say that I didn't make much. The reason it's going to say that I didn't make much is that I drilled a lot of wells last year and I was entitled to write off my intangibles which is about 70 percent of building costs.

So, because I had a big building program, I had a big tax write-off. If you look at the fact that five of those wells were very good and a couple of them were discovery wells, well I really made a ton of money last year in real terms.

It seems to me that the point of a minimum tax is that he ought to pay us a tax in line with what he tells that banker he made, rather than in line with what he told the Treasury he made.

Now, we are talking about a low tax rate where you clearly bypass things—a bunch of deductions that he could claim. Or you could do it a different way.

I was just looking this morning at all these lists of what all these people were making in these various kinds of endeavors and it looks like that on the average they are paying us taxes that amount to about 5 percent of revenue. Big companies in America in terms of income taxes.

Now, of course, applied to net they are paying us 46 percent, the way they keep their books there is only about 5 percent measured against revenue.

It would just seem to me that we should say, here is what you are going to owe us. You didn't lose—you made a lot of money and I know you told your banker that.

Right now, if we would get us a good minimum tax, that would take care of what you are worried about. I don't see why if you put the two together, we wouldn't have a good system.

Dr. JORGENSON. I think that is exactly right.

Senator LONG. Now do you two disagree with that?

Mr. RABOY. Well, there is just one point I would like to clear up. At one point you said you didn't see the difference between expensing and Professor Jorgenson's system; and Professor Jorgenson said that's exactly right.

Well, I'll tell you what the difference is. If you buy a machine and it cost you $1, under expensing you get $1. Under Professor Jorgenson's plan, you buy $1 of equipment, you might get back 70

cents, you might get back 60 cents, but you certainly are not going to get back $1.

The only thing that Professor Jorgenson's plan and expensing have in common is that you get it back at the same time, but there is a big dollar difference.

Senator LONG. Well, now hold on.

Dr. JORGENSON. I have the figures right here, Senator. I have the figure right here.

Senator LONG. Let me see if I get this straight. I thought we were talking about a 46-percent tax rate.

Mr. RABOY. Yes, I'm just talking about the deduction there.

Senator LONG. So, if you buy the machinery, if you buy $100 worth, you are going to save—what was that figure?

Dr. JORGENSON. 98 cents.

Senator LONG. I can understand that maybe we shouldn't let you expense it all. Maybe it ought to be 95 or something like that, but in any event, if we say we will let you have the first year expensing, even if we let you have the whole dollar against the dollar, it's not worth $1, it's worth 46 cents the way I understand it.

Now if you get a 10-percent investment credit, well that's worth 56 cents, but it is still not worth $1. Do you agree with that?

Mr. RABOY. That's right.

Dr. JORGENSON. Right.

Mr. RABOY. But under Professor Jorgenson's plan, it would be worth less than 50 cents.

Dr. JORGENSON. The point is that the expensing that would be provided would range from, say, 98 cents to 93 cents. It would be almost like getting a dollar. But it would preserve this effective tax rate of 15 percent that you are referring to, Senator.

Senator LONG. I get your point. But, my thought is that the way to preserve getting the minimum amount of tax that you think you ought to get, it would be by trying to write a simple alternative tax. We have tried it, but so far we haven't been very successful, because everytime we get started, somebody wants to bring an add-on tax in instead of an alternative.

Now, let me ask Mr. Strichman—are you bored with what I am trying to suggest or———

Mr. STRICHMAN. No. I am trying to make sure I understand it so I can repeat it to you. I think that what you suggested was expensing, plus the investment tax credit, is that right?

Senator LONG. That's what I am talking about.

Mr. STRICHMAN. Sir, I am with you all the way. Forget 10-5-3. Let's do that.

Senator LONG. Here is the kind of thing that I am talking about. Why don't we think in terms of how much can we afford?

Now, with what we have to work with, for example, if the administration hadn't budgeted the funds to cover 10-5-3, I don't know whether we can afford that much, but assuming we can afford it, why don't we go to a system that is as simple, as easy to administer, as fair and as neutral as we can make it, and it seems to me that if we move toward an expensing system, that is where we are going to wind up.

Now, that still doesn't settle the issue of whether we should or should not subsidize the purchase of new equipment. That's an-

other issue, but it seems to me in terms of saying it is between the 5 year, 10-5-3 and all that and just the first year expensing, I would think we would be better off with it, expressly for bookkeeping purposes--you haven't got to keep up with what year you bought the piece of equipment and all that.

Dr. JORGENSON. Precisely.

Senator LONG. You write it off the first year.

Dr. JORGENSON. Precisely, that's the whole advantage of the first year capital recovery system. Once you have written it off you are gone. The Internal Revenue Service can never come back to you and ask, you know, what did you invest last year, what did you invest the year before.

They can only ask what did you invest this year. So, once you have taken care of that, that's the only information you have to provide them, and therefore, it is the simplest conceivable system.

Senator LONG. You two agree with that.

Mr. RABOY. I think expensing is the simplest conceivable system and the program which you outlined as was explained by George Strichman here, I would support.

[The prepared statements of the presiding panel follow:]

THE FIRST YEAR CAPITAL RECOVERY SYSTEM

by

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Harvard University

Material submitted in support of testimony before the Committee on Finance, U.S. Senate, May 19, 1981.

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Real Depreciation, Real Inflation

Official Washington is convinced that a business tax cut is needed to spur industrial investment. But that is only half the battle. As the economists Dale Jorgenson and Peter Navarro point out on the opposite page, President Reagan is backing the flawed "10-5-3" accelerated depreciation approach over a more effective alternative. Congress can do better.

In a world of high inflation, the capital depreciation that companies are permitted to deduct from taxable income is often less than it costs to replace worn-out machines and buildings. Much of what the law labels as taxable profit exists only on paper. Real profit falls, and with it, the incentive to invest.

The proposed Reagan answer is to increase the tax credit for some industrial investment, and allow businesses to depreciate all investments more rapidly. His package, labeled 10-5-3 for the depreciable life of each of three investment categories, would clearly increase investment incentives by cutting taxes on profits. But the drawbacks are equally clear.

Souped-up depreciation, coupled with the more generous tax credit, favors investment in short-lived equipment over the more durable sort. Business shrugs off the problem, concentrating on the certain benefits of fast tax write-offs rather than the subtler questions of incentives. However, at a time when corporate America is being criticized for ignoring long-term planning, such a bias seems particularly perverse.

Equally important, 10-5-3 would merely give business a headstart in the race with rising costs. It would not do what most needs to be done: sever the connection between inflation and effective tax rates. If inflation speeded up, business would lose the ground it gained. If price increases slowed, corporate tax rates would fall, perhaps even below zero!

The Jorgenson-Navarro alternative would match tax depreciation schedules as closely as possible to the actual useful lives of various types of equipment. It would also break the link between inflation and investment incentives by what Professor Jorgenson and his other Harvard colleague, Alan Auerbach, call "first year" capital recovery.

Instead of providing regular depreciation allowances whose real value is determined by future price levels, the entire tax break would come in the year of the investment. That way, high inflation wouldn't raise the tax rate on corporations. Nor would low inflation reduce it. Business could live with 10-5-3 — and surely live better than with no change in the depreciation system. But that's not the real issue. Since everyone seems to agree that business taxes ought to be cut, why not make it a reform for all seasons?

The New York Times
May 5, 1981

10-5-3: 'Deeply Flawed'

By Dale W. Jorgenson and Peter Navarro

CAMBRIDGE, Mass. — There is now bipartisan consensus on Capitol Hill that business needs a tax cut to stimulate capital investment in order to improve productivity and generally revitalize America. Unfortunately, that consensus is coalescing around the Reagan Administration's highly touted, but nonetheless deeply flawed, "10-5-3" tax write-off program.

Ostensibly, 10-5-3 removes the crippling "inflation penalty" that the current business tax imposes. The penalty arises because businesses must deduct depreciation expenses according to original, rather than replacement, costs. At higher inflation rates, these deductions are worth less, so inflation in effect levies an additional tax.

The 10-5-3 approach seeks to lift this penalty through a super-accelerated depreciation plan that would allow businesses to write off depreciation on structures over 10 years, equipment over 5 years, and vehicles over 3 years. To further stimulate investment, 10-5-3 would also substantially increase the investment tax credit.

It is clear, however, that 10-5-3 does not really sever the link between inflation and investment. Instead it merely tries to "outrun" inflation. However, when 10-5-3's super-depreciation interacts with the souped-up investment tax credit, the perverse result is to transform the corporate income *tax* into a very large corporate *subsidy*. For example, at today's double-digit inflation, 10-5-3 would provide businesses with an 85 cent deduction on every dollar invested in a "5-year asset" period. The souped-up investment credit would add the equivalent of another 20 cents in write-offs so that the total tax deduction would be worth $1.05, or a 5-cent *subsidy!* Moreover, this subsidy would rise as inflation fell. Indeed, if the Administration reached its low-inflation target, the subsidy would balloon. That in turn would mean either higher personal income taxes, or a bigger budget deficit and renewed inflation.

The failure to sever inflation's capricious link with investment is not the only drawback of 10-5-3. The proposal also significantly widens the gaps that now exist between tax burdens for different investments. These gaps arise because the current system provides better tax breaks for some assets and industries than for others. That encourages a channeling of funds toward tax shelters and away from economically sound investments. Under 10-5-3 these gaps would approximately double, resulting in an even less-productive application of investment.

It is clear then that 10-5-3 confuses the real purpose of a business tax cut, which is not capital formation *per se* but rather improved productivity. In doing so, it raises the prospect of large-scale, unfair, and inefficient business subsidies that would rise and fall with the inflation rollercoaster.

But can a business tax be designed that neither penalizes nor subsidizes business, is inflation-neutral, and encourages the best use of capital?

We think that these objectives can be obtained by using the first-year capital-recovery system.

Under this system, businesses would deduct a first-year allowance in the year that an asset is acquired. Depreciation write-offs that would normally stretch out over the entire life of an asset would be converted into a single deduction, taking into account different lives of assets and the time value of money. For example, the allowance for a computer would be 82 cents on each dollar, while the allowance on a longer-"lived" building housing that computer would be 29 cents.

The advantages of the first-year system are obvious.

First, by allowing businesses to depreciate assets in the same dollars they are purchased in, it completely eliminates the inflation penalty.

Second, by matching tax write-offs with the economic cost of depreciation, it would equalize tax burdens among all assets, allowing investors from all industries and regions to compete on equal terms. That would be fairer and enlarge the economic pie by making the most productive use of every investment dollar.

Third, the first-year system is even simpler than 10-5-3 and would provide businesses with another important kind of tax relief — namely, freedom from complex reporting requirements. Indeed, the first-year allowance would be the only deduction that a taxpayer would ever have to report.

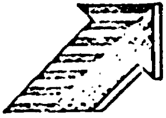
The primary disadvantage of the first-year system is, of course, its novelty.

While 10-5-3 has been kicking around Congress for more than a year and has the Reagan Administration's endorsement, the first-year system is still a relatively new idea germinating in Congressional committees.

Despite its low profile, the system does represent a constructive alternative to the seductively simple, but ultimately error-prone, super-depreciation dance of 10-5-3.

Dale W. Jorgenson is professor of economics and Peter Navarro is a teaching fellow in economics, both at Harvard University.

The New York Times
May 5, 1981



A Tax Strategy to

by A. F. EHRBAR

One of the most encouraging developments in American political attitudes is the new consensus that our tax system has become a formidable barrier to economic growth and that it needs to be drastically overhauled to restore incentives to work and invest.

With Congress no longer in the redistributive frame of mind that shaped tax legislation in the late Sixties and mid-Seventies, there is a glittering opportunity to enact a reform program that will spur productivity and growth. The Reagan Administration seems clearly determined to modify the steeply progressive structure of the personal income tax. Marginal tax rates—the rates on last-dollar income that determine whether a person is willing to take on a more exacting job or invest his money at higher risk—have risen substantially as inflation has pushed wage and salary earners into higher and higher brackets. About 20% of all taxpayers are now in the 30% bracket or higher, as against a mere 2% in 1965.

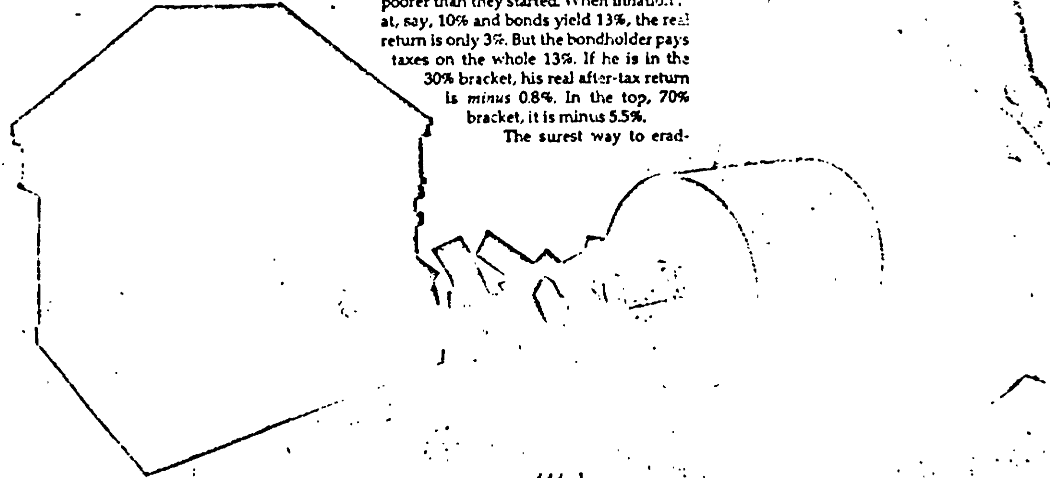
A cut in rates is sorely needed, but it is only the beginning. Two other reforms are essential to relieve the costly drag that the tax system imposes on the economy. One is to remove the system's bias against personal savings, and the other is to eliminate the debilitating distortions caused by taxes on business profits. FORTUNE has some radical proposals to accomplish these objectives.

A minus return on investment

The proposition that Americans consume too much and save too little seems indisputable. With savings rates—and accordingly, the supply of capital for investment—at depressed levels, industry is adding to plant and equipment at only half the rate of the late Sixties, the amount of capital per worker has actually been shrinking, and productivity growth is at a standstill.

The way we tax investment returns has contributed to the decline in savings. At high levels of inflation, taxes on dividends and interest often exceed the *real* return to the investor, so that investors end up poorer than they started. When inflation is at, say, 10% and bonds yield 13%, the real return is only 3%. But the bondholder pays taxes on the whole 13%. If he is in the 30% bracket, his real after-tax return is *minus* 0.8%. In the top, 70% bracket, it is minus 5.5%.

The surest way to erad-



First, effective incentives to divert more dollars from spending to savings. Second, depreciation reforms to encourage productive business investment.

Renew the Economy

icate that savage bias against savings would be to eliminate all taxes on capital income. That wouldn't be as unconscionably regressive as it might seem. For one thing, the rich can already escape taxes by putting their money in tax shelters that don't do much for economic growth or in assets that don't leave a paper trail for the IRS. As economist Milton Friedman observes, "The problem isn't really a bias against savings, but a bias against productive investment. The tax system encourages the wealthy to put their savings into gold, art, and other things that provide inflation hedges and escape taxes." Low-income workers would plainly benefit if the wealthy shifted their savings from old Packards to new factories.

Congress isn't about to let the Mellons and McCormicks off the hook, of course, but it could achieve the same measure of savings stimulus in a way that should be politically attractive. This is to allow everyone to set up tax-deferred investment and savings accounts along the lines of Keogh plans and Individual Retirement Accounts. (Employees who aren't covered by company pension or profit-sharing plans are allowed to invest 15% of their earnings, tax-deductible, up to a $1,500 annual limit, in IRAs; the self-employed can put up to $7,500 a year in Keogh plans.) Under FORTUNE's proposal there would be no limit on deductible contributions, whether they were in the form of savings-account deposits or purchases of securities; but all withdrawals—including principal as well as earnings—would be subject to taxation at ordinary rates.

Research associate: Kathleen Carroll Smyth

In its result, the tax-deferral scheme is precisely equivalent to making investment income tax-exempt. An individual who invested pretax dollars and paid taxes on total withdrawals would end up with the same amount as one who invested after-tax dollars and paid no taxes on the investment income. However, the tax-deferral method has an important equity advantage. It exempts only income from *new* savings, so that people without capital get the same break, relative to their incomes, as the wealthy. For instance, if all investment income were simply exempted from taxes, an individual with $50,000 of dividends on past investments and no wage or salary income would pay no taxes at all, while a person with a $50,000 salary and no income from past savings would pay the same taxes as he does now. This would obviously be unfair. But with tax-deferred accounts, both would pay identical taxes if they saved the same portion of their $50,000 incomes.

Critics of tax-deferred accounts complain that they are regressive because people with high incomes reap most of the benefits. That is quite true, but the tax system imposes such an enormous burden on the economy precisely because it has become so progressive. It's a defensible assumption that people at the low end of the income spectrum have more to gain from good jobs than they do from soaking the rich, and a tax system that encourages saving and investment is a key to creating jobs.

Universal tax deferral on investment income would take a large bite out of the tax base and require higher rates on the remaining taxable income. But Congress could make up the lost revenue by knocking off some other deductions. Prime candidates are the deductions now permitted for state and local taxes, property taxes on owner-occupied homes, and interest payments. Any tampering with these would be sure to provoke a howl of protest from middle-income homeowners. But a good case can be made that they will come out as well or better with tax-deferred savings accounts than they do now with their real-estate deductions. Those with a high propensity to save would do a lot better than the rest—but then that is the point of the whole thing.

A deadly deduction

In any event, the deduction on interest paid has to be repealed if large tax-deferred investment accounts are permitted. Otherwise, an individual could "game" the tax system by borrowing whatever he contributed to a tax-deferred account. By deducting his interest costs as well as his contributions, he could get a sizable

Paper sculpture by Sally Vitsky

The Irresistible Charms of the Indexed Mortgage

The most practical way to correct the tax system's bias against personal saving is to allow everybody to set up an unlimited Keogh-type investment plan, in which contributions and income would not be taxed until withdrawal (see main text). The hitch is the provision now in the tax code that makes interest payments deductible. By borrowing the money he put in his investment plan, an individual could get the tax break without doing any saving at all. But any attempt to end the deductibility of interest paid would encounter the bitter-end opposition of homebuilders and realtors—as well as millions of homeowners—who regard the deductibility of mortgage interest as a life-and-death matter.

There is, however, an ingenious way of handling mortgage payments that might overcome the opposition. This is to permit homeowners to treat down payments and payments of mortgage *principal* as contributions to their tax-deferred investment accounts. The effect would be to reverse the present treatment of mortgage charges: principal payments would be deductible, but interest costs would not.

Few people would take that option with a conventional mortgage, of course. At current interest rates, virtually the entire mortgage payment in the early years goes for interest, and hardly any of it goes to reduce the principal. But many home buyers might choose the reverse tax treatment if they got a mortgage whose outstanding balance was indexed to the price level. Such a mortgage would have a fixed real interest rate—probably in the 3% to 4% range (instead of the double-digit rates charged in recent months)—but the balance and the monthly payment would rise each year with the price indexes. The concept has been endorsed by Milton Friedman and several other economists. (See "How Not to Index the Economy," FORTUNE, November 17, 1980.) A few simple regulatory changes would permit that kind of mortgage.

It is safe to assume that a homeowner's income would keep pace with his monthly payments over the long run. And he wouldn't be in any great trouble even if his salary or wages lagged behind prices for several years because the monthly payment on an indexed mortgage would start out at a fraction of the payment on a conventional one. The initial payment on a 30-year, 3% indexed mortgage would be only a third of the payment on a 15% conventional mortgage; at 12% inflation, the indexed payment wouldn't reach the level of the conventional payment until the tenth year. The homeowner would continue to get a hefty tax break. In the first year, 41% of the monthly payment on a 3% indexed mortgage would go toward repaying principal and qualify for a tax deduction; by the eighth year, more than half the payment would be deductible.

With indexed mortgages and deductible principal payments, homeowners would get less of a tax subsidy than at present, but the demand for housing probably would rise, because the low initial payments would ease the cash-flow constraint that keeps many families out of the housing market now.

It might appear that more housing demand would leave less capital available for productive investment elsewhere. But in fact, more capital would be available. The current tax subsidy is so great that it pays to have as little equity as possible in a home. People have an incentive to borrow and buy housing, but not to save. Deductible principal payments, in contrast, would encourage homeowners to build up equity, adding to the total supply of capital for all kinds of investment.

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tax break without doing any real saving. Indeed, the tax code already contains a plethora of supposed savings incentives—such as the $200-per-person exclusion of dividend and interest income that goes into effect this year—but the interest deduction defeats the purpose.

It would obviously be unfair to end interest deductions all at once. Many people have arranged their finances on the basis of the deduction and could suffer large losses. But Congress could phase it out by gradually lowering the amount of interest that can be deducted. As for those multitudes of mortgage-holding homeowners, there is a novel way to induce them to surrender their cherished interest deduction (see box).

Various other proposals to encourage thrift have been circulating in Washington, but none seems as workable as the tax-deferred-investment approach. For instance, Representative Richard T. Schulze, a Pennsylvania Republican, is pushing a 10% tax credit, up to $1,000 per person, on purchases of stocks and bonds. Brokerage houses naturally love the idea, but it's an open invitation to game the system. A couple could borrow $20,000, buy $20,000 worth of bonds, use the interest income to offset their interest costs, and spend the $2,000 credit on a trip to Tahiti.

The false logic of 10-5-3

Any program of tax changes to encourage individual saving should be accompanied by revisions that will invite business to make more investments to improve productivity. One essential is to alter the way business depreciates its fixed assets, but not for the reasons usually advanced in favor of faster write-offs. The conventional argument is that depreciation based on original costs is inadequate in periods of high inflation. Since much of the write-off comes years after an asset is acquired, original costs don't reflect the full value of equipment used up in the production process. By taking inadequate depreciation, businesses overstate their profits and pay too much tax.

That is the logic behind the "10-5-3" proposal backed by all the major business lobbies. It provides that buildings would be written off over ten years, equipment over five years, and cars and light trucks over three. By some estimates, 10-5-3 would pare business taxes by more than $60 billion in 1985.

The analysis of inflation's effect on depreciation is correct, but the excessive-taxation argument ignores what happens on the liability side of the balance sheet. Companies get an untaxed gain when inflation reduces the value of their fixed debt. Viewed another way, the interest rate they pay is set high enough to compensate the lender not only for the use of his money but also for the deterioration in its value. So part of the company's interest costs really amount to repayment of principal—which would not, of course, be deductible if it were so defined. It turns

continued

"What we're after is productivity, not capital spending."

out that aggregate corporate tax payments wouldn't change very much if both depreciation and interest deductions were properly adjusted for inflation; some companies would pay less, others more (See "Unraveling the Mysteries of Corporate Profits," FORTUNE, August 27, 1979.)

The real trouble with the current depreciation system is that it's a mess with or without inflation. Accelerated depreciation write-offs, in use since 1954, result in different effective tax rates on investments with different lives, so that investment decisions are based on tax considerations rather than real returns. Such misallocation of capital results in less output and slower growth, even when prices are stable. Inflation merely shifts the tax preference to different assets.

The 10-5-3 plan, and variations on it, would distort investment returns in the same way as the current accelerated write-offs. Moreover, the combination of 10-5-3 and the investment credit would give rise to outright tax subsidies. It would be even more generous than simply allowing a company to deduct the whole cost of a capital investment when it is made.

A distortion-free system

Two Harvard economists, Dale Jorgenson and Alan Auerbach, have advanced a proposal that would do away with the concept of accelerated depreciation and match write-offs to true economic depreciation. Write-offs would be calculated so that they corresponded as closely as possible with the actual deterioration of a piece of equipment. But companies would be allowed to take all depreciation write-offs in advance, when they acquired the equipment. This would eliminate the distortion caused by inflation because purchases and depreciation allowances would be in dollars with the same value.

Depreciation that will occur in the future would be discounted back to the time of purchase at a 4% interest rate—so that, for instance, the $1 million of depreciation that would take place in the second year would be written off immediately, but the company would take a tax deduction of only $961,538. Why 4%? Because Jorgenson and Auerbach believe that is the best estimate of the average real return on business equipment. That figure may be open to dispute, but it's hard to fault the basic concept.

The Jorgenson-Auerbach approach, known as "present value" depreciation, sounds complex but is really quite simple. They figure that all assets can be divided into just 12 to 14 categories, ranging from construction machinery to commercial buildings. To establish the depreciation, you would just consult a Treasury table for the category "factor," and multiply the factor by the cost.

As part of their scheme, Jorgenson and Auerbach favor dropping the investment tax credit. The credit applies only to capital equipment, not structures. There is no doubt that it has boosted spending on equipment (and the number of doctors driving Mercedes-Benzes). But a study that Auerbach and Lawrence Summers, an MIT economist, did for the National Bureau of Economic Research suggests that more than half of the added investment attributable to the credit came at the expense of other kinds of investment, namely in housing and industrial plant. To that extent, the credit crowded out other prospective investments that offered higher economic returns. As Jorgenson observes: "What we're after is productivity, not capital spending."

The bankers' lobby

A second change in corporate taxation that would foster larger and more productive investment is to eliminate the double taxation of dividends. (The corporation pays dividends out of after-tax profits, and stockholders then pay personal income tax on the dividends.) Double taxation distorts investment by causing capital to flow to non-corporate ventures (for example, limited partnerships in shopping centers and motels). In 1978, Al Ullman, then chairman of the House Ways and Means Committee, proposed giving shareholders a tax credit for part of the taxes paid by the corporation. The flaws in Ullman's plan were, first, that it didn't go far enough; second, that the tax credit wouldn't have been available to tax-exempt investors such as pension funds; and third, that shareholders wouldn't have received a credit for foreign tax payments. Even so the dividend credit was a beginning, and its shortcomings could have been corrected later.

Unfortunately, business—notably the big banks—helped kill the idea. One Congressman recalls, "David Rockefeller was down here lobbying door to door in the House office buildings to stop Ullman." The banks objected to the plan because their large foreign tax payments and their special legal right to deduct interest costs while investing in tax-exempt bonds leave them with extremely low U.S. tax bills. Thus they had less to gain than other corporations from a dividend tax credit, and they feared that Ullman's plan would erode some of the comparative advantage they enjoy in the competition for capital. Since then, double taxation has dropped out of sight as a reform issue.

The pursuit of special advantage, has also figured in the lobbying for depreciation changes. While the Jorgenson-Auerbach present-value depreciation would foster more economic growth, it is less generous than 10-5-3 to capital-intensive industries such as autos, steel, airlines, and utilities. Their lobbies have stuck by 10-5-3.

Business's dismal record of putting its parochial interest above the general good is the darkest cloud over Washington's new approach to taxes. Congress, after all, is a reactive body that ultimately adopts the measures the electorate demands. An important prerequisite for successful reform is that business, one of the loudest and most effective lobbies, get behind changes that promote general efficiency and growth. In the long run, such reforms will redound to the greater benefit of both business and society. Ⓕ

"A businessman should spend his money for the maximum increase in efficiency, and not just to take advantage of a new tax wrinkle."

A Difference of Opinion

A Better Way to Boost Capital Spending

"Supply-side economics" is Washington's fashionable new rubric for tax cuts designed to encourage businessmen to spend more on new plant and equipment. More capital invested per worker means higher productivity, higher real incomes, and lower inflation.

As supply-siders see it, capital spending has been crippled because the tax deductions companies can take for the depreciation of their assets are unrealistically low. The deductions are spread out over periods ranging up to 40 years or more, and they are limited to the purchase price of the assets, even though the cost of replacing assets in a period of high inflation may have tripled.

The supply-side proposal with the broadest support is the Capital Cost Recovery Act introduced last year by Barber Conable, the ranking minority member of the House Ways and Means Committee, and James Jones, a committee member from the Democratic side. Their bill would allow much faster write-offs for most assets—ten years for structures, five for equipment, and three for vehicles. This is a crude but effective solution. The artificially rapid depreciation schedules might roughly compensate companies for the higher costs they would be facing once the equipment really did wear out.

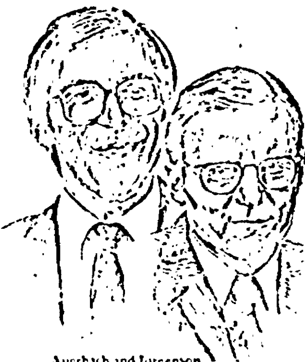
Two of the most knowledgeable critics of "ten-five-three" are Dale Jorgenson, a Harvard economics professor who has done a lot of work on productivity problems, and Alan Auerbach, an assistant professor at Harvard. They support the aims of Conable and Jones but think that the effects of inflation on the cost of replacing assets can be dealt with in a more precise and scientific way. They discussed their alternative to the Conable-Jones proposal with FORTUNE's Eduard Meadows.

Q. What's wrong with ten-five-three?

JORGENSON: It doesn't get at the biggest problem. Under ten-five-three, depreciation allowances are still based on historical costs, though the allowances are much more generous than under the present system. The fairness of any capital recovery scheme that is based on historical costs and is spaced out over time is going to be affected dramatically by changes in the inflation rate. When inflation goes up, a company is going to get less benefit, to the extent that the dollars it can deduct for depreciation are less valuable than the ones it used to buy an asset.

Just how a company would fare on any given investment under ten-five-three depends on two offsetting factors: the benefit of a rapid depreciation schedule on the one hand and the ravages of inflation on the other. I won't burden you with the arithmetic, but the results we get for an investment in construction machinery, which qualifies for the investment tax credit and would have a five-year write-off period under Conable-Jones, are these: At a 12% inflation rate, the purchaser would pay an effective tax rate of 16%—not bad compared with the corporate tax rate of 46%. At 6% inflation, which we had as recently as 1976 and could have again, he would enjoy a tax subsidy of 23%.

A second problem with ten-five-three is that it gives corporations incentives to buy some kinds of assets that may not raise productivity a lot. You get to write off structures in 10 years though their economic lifetime is really 30 or 40 years, so this gives you a very low effective tax rate on buildings. Long-lived industrial equipment does even better. But some very useful purchases—pickup trucks, for example—can already be written off quickly and wouldn't get any new tax break at all. What we want is a system that eliminates the disincentive to capital investment but does so in a neutral way. A businessman should spend his money for the maximum increase in efficiency, and not just to take advantage of a new tax wrinkle.



Auerbach and Jorgenson

Q. Can't you just change the numbers around and make it "fifteen-five-three," for example?

AUERBACH: You can change the numbers around and lessen the bias, but no matter what numbers you use, the proposal is still very sensitive to the inflation rate, and you can't predict what that is going to be.

Q. Well, what is your alternative?

JORGENSON: We call it the First-Year Capital Recovery System. You get your full depreciation allowance in the same year you buy an asset, rather than getting a little each year. The whole point of our plan is that since you are getting your depreciation deduction in the same dollars you spent to buy an asset, there is no way inflation can affect the outcome.

Q. How do you figure out the amount of the deduction?

JORGENSON: Since assets actually depreciate over a number of years, as they are used up and wear out, it's necessary to calculate the present value of future depreciation. In other words, you convert all your future depreciation allowances to what they would be worth this year. Discounting future sums to their present value

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A Difference of Opinion *continued*

is something that financial planners routinely do on their pocket calculators. It is the reverse of compounding interest, and in this case its purpose is to let the buyer of assets take his depreciation today, in the same dollars he used to buy the asset.

Q. So for a certain asset, all you need to find out is its average lifetime and an appropriate discount rate?

JORGENSON: It's much simpler than that. All a businessman would have to do would be to look up a present-value number for a particular investment. It could be printed in a single table that listed, say, 30 or 40 different classes of assets—maybe 10 kinds of structures and 20 types of equipment. For each class there would be a single present-value number that tells the asset purchaser how much he gets back on the dollar. For instance, the table might tell a taxpayer that he would receive 50 cents for every dollar's worth of investment he made last year in industrial buildings, and perhaps 80 cents for each dollar spent on construction machinery. The actual amount would depend on the life of the asset and the discount rate.

So instead of keeping track of all past assets and depreciating them every year, you never have to go through all that bother. The system is going to be far easier for business. Small businessmen may even be able to handle their taxes without an accountant, because a lot of what the accountants do is to apply these very complex depreciation rules now in the tax code.

Q. But how do you get a discount rate?

JORGENSON: Since we're talking about the rate of return on physical assets here rather than financial assets, the return on assets is more appropriate than the real interest rate. We took corporate profit data, adjusted them for inflation, and divided the profit numbers by the capital stock to get a long-term rate of return on all the assets in the economy. It came out at 4%. That has been pretty stable over the years, so we use 4% as the discount rate.

Q. How would the businessman come out in terms of tax savings under your plan, as opposed to ten-five-three?

JORGENSON: It turns out that it would be about the same for the first five years. In other words, the Treasury Department would give up a total of about $55 billion in revenues over the first five years under either plan, but beyond that, the tax-revenue loss under ten-five-three really balloons, although capital investment doesn't go up more. Businessmen would be better off under ten-five-three, but that bill would drive the federal budget way into the red.

Q. So for the first five years, your plan would stimulate capital spending as much as ten-five-three?

JORGENSON: Yes. We figure both proposals would raise capital spending by an extra 7% a year. That's about $16 billion more per year. If you don't think 7% more is enough, then you could combine our plan with cuts in the corporate tax rate. You might reduce the rate from 46% to somewhere in the low 40's.

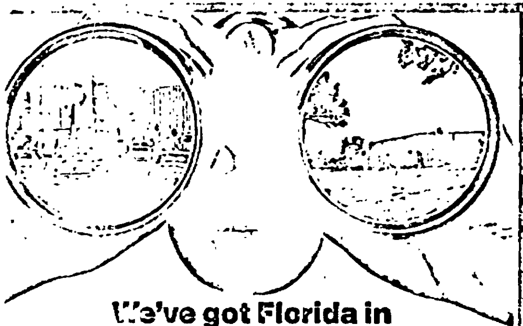
Q. [illegible] years? What [illegible] to revenues under your scheme?

AUERBACH: What we are doing is shifting the government's revenue loss from future years to the year that investments are made. So after five or six years the tax-revenue losses would decline a lot. There would be lump-sum deductions for investments made in any given year, but no carry-over deductions from earlier years.

Q. Have you tried this on Congress?

JORGENSON: We've testified before the Senate Finance Committee, the House Ways and Means Committee, and both budget committees. The response has been good. They are able to understand the proposal because it is extremely simple. In fact, the main selling point is the great ease of administering the system.

continued



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A Difference of Opinion *continued*

Q. Do you consider yourselves supply-side economists?

JORGENSON: We are "supply-and-demand-side" economists. If you claim that any tax cut, chosen at random, will give you enough of an increase in economic activity to actually increase tax revenues—that is a joke. You have to look at each particular program. To my mind it's an empirical matter. But to settle the empirical question you have to combine both demand and supply considerations. It's very important to ask whether the labor force and the capital stock are fully utilized. Those are demand-side questions. It also matters how many people—housewives, for example—are staying home because the family's tax rates would be prohibitively high if they went to work. Those are supply-side issues. I don't see how you can have a rational economic policy without looking at both sides.

Q. How long would it take for supply-side proposals to begin paying off?

JORGENSON: The time lag for tax incentives relating to individuals wouldn't take more than a couple of years.

Q. That sounds like an endorsement of Kemp-Roth—a 30% tax cut over three years.

JORGENSON: Well, I think it would be inflationary to pump that much money into tax cuts without some big cuts in federal spending. But if you really did cut personal tax rates so a lot of people would work more, it would spread through the economy very quickly.

Tax cuts on the income from capital would take more time to have effect. People would realize right away that it had become a lot more attractive to accumulate capital, but the shift away from consumption and into investment would take at least five years and could take as long as ten. The payoff to society would be tremendous, however, and it is something we need to get started on. [F]

Inflation-proof depreciation of assets

Alan J. Auerbach and Dale W. Jorgenson

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V·2.

Inflation-proof depreciation of assets

Recovery of the capital expenditure in the year of purchase would cancel out inroads of severe inflation

Alan J. Auerbach and Dale W. Jorgenson

How can a business renew its plant and equipment when the depreciation rates allowed by law cannot keep up with the economic depreciation wreaked by rampant inflation? The answer is, it can't for very long. That's why there is a movement afoot to do something about the situation; indeed, a bill before Congress has gained wide support in both houses and in the business community. This "10-5-3" system would spread recovery of the investment over no more than ten years. But that proposal has serious deficiencies, the authors of this article maintain. They present a procedure by which the present value of economic depreciation would be allowed as a tax deduction in the same year the asset is acquired. By comparing this idea with the 10-5-3 scheme and with the procedure under current tax law, then simulating the economy for 1981-1985 to show the effect on the federal budget, the authors demonstrate that their first-year capital recovery system would be a distinct improvement.

Mr. Auerbach is an assistant professor and Mr. Jorgenson a professor in the Harvard economics department. Author of articles in several economics journals, Auerbach is also a research associate with the National Bureau of Economic Research. Jorgenson, who has contributed to many publications, has held professorships at several universities besides Harvard. He has served in editorial posts on the *American Economic Review* and other economics journals. In early 1980 the authors presented their proposal for a first-year capital recovery system to the Senate Finance Committee and the House Ways and Means Committee.

Since 1973, while the U.S. economy has been suffering from unprecedented rates of inflation, capital formation has stagnated and economic growth has slowed considerably. A very important reason for the capital stagnation is the widening gap between economic depreciation and capital consumption allowances for tax purposes. As a result, businesses cannot recover the real costs of their investments in plant and equipment.

Growing misallocations of capital, caused by distortions in depreciation allowances under the tax system, have further diminished the contribution of capital to productivity growth. Inflation exerts a differential impact on assets with different useful lives; and the greater the inflation rate, the greater the distortions in depreciation among asset classes.

The system for capital recovery governed by tax law has developed through many liberalizations of depreciation formulas and lifetimes for tax purposes and through the investment tax credit. One motive for these changes was the need to bring capital consumption allowances into line with economic depreciation. Double-digit inflation in recent years, however, has undercut the effectiveness of these reforms, so that revision of the depreciation provisions of the tax code is again under serious consideration.

The most widely supported proposal for revision is the bill introduced in the last session of Congress by Representatives Barber B. Conable, Jr., and James R. Jones. The measure, widely endorsed by business

Authors' note: We wish to express appreciation to Martin Sullivan for very able research assistance and to Otto Eckstein for permission to use the Data Resources, Inc. quarterly model in the simulation of the U.S. economy reported in this article.

groups and supported by nearly 300 of the 435 members of the House and 51 of the 100 members of the Senate, proposes a "10-5-3" method of capital recovery. Structures would be written off in ten years, long-lived equipment in five years, and short-lived equipment (such as light trucks and autos) in three years. The bill would retain the investment tax credit for equipment.

Laudable as it is in its simplicity and liberality, the 10-5-3 idea is not the best solution. We propose a better approach, based on the recovery of capital consumption during the year the asset is acquired. Hence depreciation allowances would be unaffected by inflation or by variations in the rate of inflation.

Our so-called first-year capital recovery system directly attacks the problem confronting tax policymakers: to design an approach that can cope with high, moderate, and low degrees of inflation without the distortions resulting from the tax structure in use. The first-year system would greatly stimulate capital formation and enhance its impact on productivity and economic growth.

Admittedly, the 10-5-3 approach would give a substantial impetus to capital formation. Much of that effect, however, would still be dissipated through misallocations of the capital stock. The Conable-Jones proposal would widen, rather than narrow, the substantial differentials in tax burdens that classes of assets now bear.

In addition, these differentials would become more sensitive to variations in the rate of inflation. Subsidies of some types of assets would replace taxes under moderate inflation rates, and these subsidies would grow dramatically under low inflation rates.

In this article we describe the first-year capital recovery system and compare it with capital recovery under current tax law and under the Conable-Jones proposal. Then we analyze the macroeconomic impact of the first-year system by simulating the U.S. economy under the assumption that the structure will be phased in over the five-year period 1981-1985.

The first-year system ...

Under our proposal, taxpayers could deduct the present value of economic depreciation as an expense in arriving at income for tax purposes. To avoid inflation-caused deterioration in the value of capital consumption allowances, the present value of economic depreciation would be allowed as a deduction in the same year that an asset is acquired.

(To arrive at present value, future depreciation must, of course, be discounted back to the present. For example, the present value of one dollar's worth of investment in a long-lived asset such as a manufacturing plant might be 50 cents, while the present value of one dollar's worth of investment in a short-lived asset such as a pickup truck might be 75 cents.)

Capital consumption allowances would be described by a schedule of present values of economic depreciation for one dollar's worth of investment in each class of assets. We propose use of about 30 classes—perhaps 10 types of structures and 20 types of equipment. The whole arrangement could be described in terms of only 30 numbers.

Rather than, as now, choosing among a range of asset lifetimes and a number of depreciation formulas, taxpayers would simply apply the particular first-year capital recovery allowances to their purchases of depreciable plant and equipment. No purchase records would be necessary to substantiate allowances taken in a given year.

Many assets are sold before the end of their useful lives. To ensure efficient allocation of the existing capital stock, it is important to provide for capital recovery on used assets. Under current tax law, to arrive at a basis for resale the purchase price is reduced by the capital consumption allowances. If the proceeds from the sale exceed this basis, the taxpayer is subject to tax on the difference.

Under the first-year capital recovery system, a buyer of a used asset could deduct the present value of economic depreciation on it in the year of acquisition. The seller of a used asset would be subject to ordinary income tax on the same amount; this amount would always be less than the price of the asset. If purchasers and sellers have the same marginal tax rates, transactions in used assets would not affect federal revenue.[1]

Would the establishment of large deductions in the first year of investment encourage creation of tax shelters? Perhaps high-bracket taxpayers could purchase assets to take the deductions, then lease

1 Here we are consistent with the principle of tax neutrality of exchanges of assets proposed by Gerard M. Brannon and Emil M. Sunley, Jr. See their article, "The 'Recapture' of Excess Tax Depreciation on the Sale of Real Estate," *National Tax Journal*, December 1976, p. 413.

2 Charles Hulten and Frank Wykoff, "Tax and Economic Depreciation of Machinery and Equipment. A Theoretical and Empirical Appraisal," Report to the Office of Tax Analysis, U.S. Department of the Treasury, 1979.

3 This rate is suggested in Barbara M. Fraumeni and Dale W. Jorgenson, "The Role of Capital in U.S. Economic Growth, 1948-1976," in George von Furstenberg, ed., *Capital, Efficiency and Growth* (Cambridge, Mass.: Ballinger, 1980).

the assets to low-bracket taxpayers using them in production. Actually, the new procedure would, if anything, discourage such leasing schemes and other tax shelters based on capital recovery. While high-bracket buyers would obviously get a bigger deduction in the first year, they would lose all subsequent deductions. This is a trade-off similar to that faced by prospective low-bracket purchasers.

It is reasonable to assume that high-bracket individuals have a lower discount rate than others do, precisely because they must pay a higher rate of tax on capital income. Low-bracket investors, with a higher discount rate, would perceive the conversion of all future deductions to a single current deduction as generous. They would prefer to acquire assets directly instead of lease them from high-bracket individuals.

Administrative aspects

The first-year system would greatly reduce the administrative burden imposed on taxpayers and tax authorities. Taxpayers could dispense with the cumbersome systems of capital accounts for tax-reporting purposes. Since tax liabilities and deductions arising from transactions in new and used assets would depend only on the prices paid, taxpayers would not need to keep records of past transactions.

The results of a study for the Treasury Department in 1979 by Charles Hulten and Frank Wykoff demonstrate the feasibility of a system for capital recovery that covers structures and equipment by a uniform method.[2] Like the present approach, this method would be based on a system of asset classes, but they would be far fewer than those in the asset depreciation range (ADR) system used now.

The declining-balance method for estimating economic depreciation would be employed for all assets. The rate of decline of the price of assets with age could be estimated for each asset class on the basis of Hulten and Wykoff's methods. The real rate of return could be taken to be 4%.[3] Distortions caused by departures from perfect measurements of economic depreciation or the real rate of return would be very small compared with distortions under current tax law or 10-5-3.

Although the first-year system would not rely on data required for financial reporting, it could be integrated with a financial reporting procedure and thus lead to major simplification. At present, many taxpayers maintain separate sets of books of capital accounts for tax purposes and for financial reporting. Since the new system would not require capital accounts, one set could be eliminated.

Exhibit I
Selected assets and their characteristics

Asset class	Type	Years of tax life[1]	Economic depreciation rate[2]	Percentage of 1974 nonresidential investment
Construction machinery	Equipment	5.5 (7.0*)	.172	2.8%
General industrial equipment	Equipment	8.8	.122	4.4
Trucks, buses, and trailers	Equipment	5.5 (7.0*)	.254	9.0
Industrial buildings	Structures	23.8	.036	5.2
Commercial buildings	Structures	31.8	.025	11.0

1 Equals guideline lives for structures and 80% of guideline lives for equipment, as legally permitted (* except where a lengthening of the tax lifetime is preferred in order to obtain a full investment tax credit)

2 Annual rates of decline in asset value with age as estimated by Hulten and Wykoff

Exhibit II
Effective tax rates under three capital recovery systems

Asset class	Current system*		Conable-Jones†		First-year
	6% inflation rate	12% inflation rate	6% inflation rate	12% inflation rate	
Construction machinery	.06	.34	−.23	.16	.46
General industrial equipment	.16	.36	−.17	.13	.46
Trucks, buses, and trailers	.09	.42	.22	.45	.46
Industrial buildings	.49	.53	.36	.43	.46
Commercial buildings	.48	.51	.32	.39	.46

Note: The real discount rate is assumed to be 4%

*Assumes adoption of the double-declining balance method (equipment) or 150% declining balance method (structures), with optimal switchover to straight-line, plus a 10% investment tax credit on equipment

†Assumes tax lives of five years (equipment) or ten years (structures), plus a 10% investment tax credit on equipment

Rather than require a system of vintage accounts, as in the ADR approach, the declining-balance method would oblige the taxpayer to maintain a single account for each asset class. Capital recovery would be a constant fraction of the undepreciated balance remaining from all previous expenditures on assets in that class.

If, in addition, some kind of reevaluation were necessary for financial reporting purposes, the undepreciated balance in each account could be revalued at the end of each accounting period. The basis would be the change in the acquisition prices of new assets during that period.

... against two others

To compare the first-year capital recovery system with that under existing law and with the 10-5-3 proposal, we have analyzed their impact on five representative classes of assets (see *Exhibit I*). For each asset we give the tax lifetime embodied in current law and the economic depreciation rate as calculated in the Treasury Department study. We also give the proportion of nonresidential investment in 1974 for each asset class. Together these five assets accounted for about one-third of all investment that year.

To analyze the impact of changes in capital recovery provisions of the tax law after World War II, we calculated the effective tax rate for each class of assets.

As the table in the Appendix to this article shows, the effective tax rates for the five asset classes have varied widely since 1952, depending on the provisions of the tax code and the rate of inflation. The figures we use in our analysis represent the average tax rate for each new asset over its lifetime.

Exhibit II compares the effective tax rates for the five classes of assets under current tax law, the Conable-Jones approach, and the first-year system. Because the effective tax rates under the first two systems depend on the degree of inflation, we calculated those rates at 6% and 12% inflation. The effective tax rate under the first-year system, of course, equals the statutory rate and is unaffected by inflation.

Current tax law imposes a greater tax burden on structures than equipment, so the allocation of the capital stock is biased toward the latter. More output could be produced from the existing capital stock by a shift in its composition from equipment toward structures.[4]

The most striking feature of the Conable-Jones proposal is the substantial reduction in effective tax rates for all assets. In fact, with either 6% or 12% inflation, the effective tax rates under 10-5-3 would fall below the 46% statutory rate. Conable-Jones, however, has a very undesirable feature: in a time of moderate inflation, such as a 6% rate, the combined effect of greatly accelerated depreciation and the investment tax credit would produce negative tax rates for construction machinery and general industrial equipment. Rather than tax income produced by the assets, the government would, in effect, pay taxpayers to hold them!

As *Exhibit II* indicates, the current system causes sizable distortions of economic depreciation, and the size depends on the inflation rate. The Conable-Jones proposal would create greater gaps between capital consumption allowances and economic depreciation than under current law, and these gaps would be more sensitive to the rate of inflation.[5] Under the first-year capital recovery system, capital consumption allowances would equal economic depreciation under any degree of inflation.

Future economic impact

In view of the emphasis today on reducing the federal deficit to combat inflation, a critical issue in tax reform is the effect of a proposed change on the budget. To assess the macroeconomic impact of adoption of the first-year system and its impact on federal revenue, we simulated the U.S. economy under the assumption that the system had been adopted for tax years beginning in 1981. (We assumed that any shortfall would result in creation of additional government debt and that the Federal Reserve would not adjust monetary policy to accommodate a revenue loss.)

We supposed that the system would be phased in over five years. In the 1981 tax year, 20% of the value of assets acquired would be included, and 20% more in each subsequent year until 1985, when all capital assets installed would be included. This pattern coincides with those following the liberalization of depreciation allowances in 1954 and the shift to the ADR system in 1971.

The results of our simulation, using the Data Resources, Inc. (DRI) quarterly econometric model of the U.S. economy,[6] can be seen in *Exhibit III*. The base line simulation, denoted B, traces the course of the economy without the first-year capital recovery system. The alternative simulation, denoted A, assumes adoption of the new approach and discontinuance of the investment tax credit. The difference between the two simulations, denoted D, shows the impact of the new procedure. We also give the difference in percentage terms.

4 For a treatment of capital investment biases under current tax law, see Alan J. Auerbach, "Inflation and the Choice of Asset Life," *Journal of Political Economy*, June 1979, p. 621.

5 For further discussion of the Conable-Jones bill and other capital recovery systems, see Martin Feldstein, "Adjusting Depreciation in an Inflationary Economy: Indexing versus Acceleration," *Discussion Paper No. 731* (Cambridge: Harvard Institute for Economic Research, December 1979).

6 For a description of the model, see Otto Eckstein and Allen Sinai, *The DRI Model of the U.S. Economy* (Amsterdam: North-Holland, forthcoming).

As *Exhibit III* demonstrates, the new system provides a very substantial stimulus to capital formation. By 1985, real investment in equipment has grown by $6 billion and real investment in nonresidential structures by $9.1 billion. The greater stimulus to the latter is the result of removal of the distortions between capital consumption allowances and economic depreciation that exist under current law. (Although the system offers no particular incentive to owner-occupied housing, real investment in residential structures increases by $2.3 billion in the five years.)

DRI forecasts a declining, but still high, unemployment rate through 1985. The first-year system, according to the simulation, would reduce the rate somewhat by 1984.

The stimulus to investment would increase the real gross national product by substantial amounts. The inflation rate, as measured by the GNP deflator (not shown in *Exhibit III*), would rise by .2% per year by 1984.

As a result of adoption of the first-year system, the projected federal deficit for 1981 would be turned into a surplus—partly because of elimination of the investment tax credit. Thereafter the federal accounts would show surpluses with both simulations, but lower surpluses under the first-year system. The revenue loss during the five years would total $50.9 billion.

Exhibit III
Five-year impact of the new system
(except for the unemployment rate, figures in billions of dollars)

	1981	1982	1983	1984	1985
Gross national product*					
A	1430.5	1485.6	1537.0	1597.4	1648.7
B	1430.6	1487.1	1531.2	1582.8	1635.3
D	−0.1	−1.5	5.8	14.6	13.4
%	−0.0	−0.1	0.4	0.9	0.8
Investment, producers' durable equipment*					
A	97.6	94.4	94.8	101.2	107.8
B	97.8	98.9	98.2	99.1	101.8
D	−0.2	−4.5	−3.4	2.1	6.0
%	−0.2	−4.6	−3.5	2.1	5.9
Investment, nonresidential structures*					
A	47.1	47.7	50.6	54.9	59.2
B	47.0	46.7	47.1	48.4	50.1
D	0.1	1.0	3.5	6.5	9.1
%	0.2	2.1	7.4	13.4	18.2
Investment, residential structures*					
A	45.7	59.6	66.8	73.9	74.7
B	45.5	57.8	62.3	69.3	72.4
D	0.2	1.8	4.5	4.6	2.3
%	0.4	3.1	7.2	6.7	3.2
Unemployment rate					
A	8.0	7.7	7.4	6.9	6.5
B	8.0	7.7	7.5	7.2	6.8
D	0.0	0.0	−0.1	−0.3	−0.3
%	0.0	0.0	−0.8	−4.3	−4.4
Federal surplus					
A	1.0	14.5	10.2	22.6	21.1
B	−4.0	20.5	19.4	34.6	49.8
D	5.0	−6.0	−9.2	−12.0	−28.7
%	−123.8	−29.3	−47.4	−34.7	−57.6

Note: Based on DRI's six-year control simulation as of April 28, 1980
*1972 dollars

A better way

In considering measures to stimulate U.S. economic growth, policymakers should give top priority to the design of a new approach to capital recovery. Such an arrangement should bring capital consumption allowances into line with economic depreciation. It should also enhance the impact of capital formation on economic growth through more efficient allocation of capital.

The first-year capital recovery system would eliminate the differentials between economic depreciation and capital consumption allowances that have arisen under current law. These allowances would be unaffected by inflation or by variations in its rate. At little revenue loss to the federal government, the system would give capital formation a great boost. It would also improve the allocation of capital and maximize the contribution of capital formation to growth in productivity and economic activity.

The first-year approach could be implemented within the present framework of the Treasury Department. Simplification of the system would greatly ease the administrative burden on the tax authorities. Moreover, it would drastically reduce taxpayers' reporting requirements and permit easy integration with their financial reporting procedures.

(See the Appendix on next page.)

Appendix

The effective tax rate represents that fraction of a project's gross income that goes toward corporate taxes. To obtain the number, we first calculated the gross rate of return an investment would have if the corporate tax rate were zero. We then calculated the net rate of return, taking account of corporate taxes and adjusting for capital consumption allowances and the investment tax credit. We subtracted the net rate of return from the gross rate of return and divided this difference by the gross rate to find the proportion of the gross return paid in taxes.

The table presents the effective tax rates for all five classes of assets from 1952 through 1979. For purposes of comparison, we give the statutory rate on corporate income each year.

Before 1954 the effective tax rates for structures were in line with that statutory rate, while those for equipment far exceeded it. Inauguration of accelerated depreciation in 1954 changed the situation somewhat, but the effective tax rates for equipment remained above statutory rates until the adoption of the guideline lifetimes and the investment tax credit in 1962. The repeal of the Long Amendment in 1964 caused a further reduction in rates on equipment to levels well below the statutory rate.

As the pace of inflation quickened during the late 1960s, the effective tax rates on equipment rose gradually, until repeal of the investment tax credit in 1969 raised them to the pre-1962 levels. Similarly, inflation and restriction of accelerated depreciation on structures to the 150% declining-balance method after 1966 resulted in increases in the effective tax rates for structures to levels exceeding those before 1954.

Reinstitution of the investment tax credit for equipment in 1970, adoption of the asset depreciation range system in 1971, and the increase in the rate of the credit from 7% to 10% produced effective tax rates well below the statutory rate, even in the face of double-digit inflation in 1973 and again in 1979.

Table
Effective tax rates, 1952-1979

Year	Statutory tax rate	Construction machinery	General industrial equipment	Trucks, buses, and trailers	Industrial buildings	Commercial buildings
1952	.52	.57	.59	.66	.51	.51
1953	.52	.57	.59	.65	.51	.51
1954	.52	.58	.60	.66	.52	.52
1955	.52	.58	.60	.66	.52	.52
1956	.52	.54	.57	.62	.49	.49
1957	.52	.54	.57	.62	.49	.49
1958	.52	.54	.57	.62	.50	.50
1959	.52	.56	.58	.63	.50	.50
1960	.52	.56	.58	.63	.51	.50
1961	.52	.54	.57	.62	.50	.50
1962	.52	.41	.43	.49	.49	.49
1963	.52	.40	.43	.49	.49	.49
1964	.52	.31	.34	.38	.48	.48
1965	.48	.26	.29	.34	.45	.45
1966	.48	.35	.38	.43	.46	.46
1967	.48	.37	.40	.45	.47	.47
1968	.48	.35	.38	.43	.48	.48
1969	.48	.53	.56	.61	.52	.51
1970	.48	.43	.44	.51	.53	.52
1971	.48	.35	.37	.42	.53	.52
1972	.48	.35	.37	.43	.53	.52
1973	.48	.39	.40	.47	.54	.53
1974	.48	.43	.44	.51	.55	.54
1975	.48	.33	.36	.40	.56	.54
1976	.48	.34	.37	.42	.56	.54
1977	.48	.37	.39	.45	.56	.55
1978	.48	.36	.39	.44	.56	.55
1979	.46	.32	.35	.39	.54	.53

Note: Assumes the real discount rate to be 4% and the relevant inflation rate to be an unweighted five-year moving average of past inflation rates.

The Great Productivity Debate

The Answer Is Energy

INTERVIEW | DALE W. JORGENSON

Q. You are at the center of an important controversy over productivity performance in the United States. There are two levels of debate: researchers are haggling over the methods of measuring the sources of growth and productivity changes; and in Washington, the Congress and policy-makers are hotly debating the programs they ought to adopt to improve productivity performance.

Would you give some background on these issues? Where have we come from in terms of productivity growth? Where are we headed?

A. The growth of the U.S. economy has been very rapid by historical standards. The rate of economic growth reached its maximum during the period 1960-66, and then it slowed down, and declined even further since 1973. Economists look for the major sources of growth in order to form a picture of the economy's future performance. The big question is whether the American economy in the future will move along the rapid growth path of the early 1960s, or follow the more moderate expansion of the late 1960s and early 1970s, or falter in the disappointing growth patterns since 1973.

Q. What were the most important sources of growth in the period since World War II?

A. In my view, American economic growth during 1948-76 was derived from additions to the capital stock—in other words, capital input—increased use of labor, or labor input, and improvements in productivity. According to my research findings, expansion of capital input made the most important contribution to the growth of national output in this period—accounting for roughly half of our growth. Productivity growth appeared as the next most important source, contributing almost a third,

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and the growth of labor input contributed the remainder.

Q. How do you explain the fall in the growth rate since 1973?
A. The most important cause appears to be the dramatic decline in productivity growth. Declines in the contributions of capital and labor inputs are much less significant in explaining the slowdown. That leads me to my conclusion that the future growth of productivity is the key, and also the main source of uncertainty in projections of future U.S. economic growth.

Q. How do your views on long-term growth sources contrast with Edward Denison's?
A. Denison put his primary emphasis on productivity growth in contrast with my emphasis on capital formation.

Q. But I thought Denison listed three factors as the major sources of growth: economies of scale; more efficient reallocation of resources; and advances in knowledge underlying his unexplained "residual."
A. Exactly, whereas in our story, if you follow the statistical methods we think appropriate, you allocate much more growth to the expansion of capital and less remains in the unexplained residual.

Q. Would you explain more about how your methodology differs from Denison's?
A. In our long exchange of views with Denison, now almost a decade long, there are really two major steps we have taken in our methodology. First, in order to analyze in greater detail the productivity slowdown in the U.S. economy as a whole, we disaggregated the data to the sectoral level. This enabled us to look at the role of intermediate inputs into production processes, such as energy and materials, as well as the contribution of labor and capital. Consequently, we had to discard the approach used by Denison and John W. Kendrick, who based their analysis on growth in value added. To get a handle on the contribution of intermediate inputs meant we had to measure growth in terms of *gross*, not net, output at the sectoral level.

Q. What do you mean by the sectoral level?
A. I mean the level of individual industrial sectors. We disaggregated the American economy into some 35 industries including services and the government sector. We developed data on intermediate inputs based on input/output data and broke that down between energy and non-energy intermediate inputs. If you attempt to measure the contributions toward growth using value-added at each stage of production, you automatically eliminate the role of energy and materials. That may not have been a serious problem before the oil price revolution in 1973-74. That exclusion, however, introduced a large error after 1973.

Q. Now what was that second major step?
A. The second crucial advance in our method occurred only two years ago. We related that part of growth not accounted for by increases in inputs of capital, labor, energy, and materials—the unexplained residual in our analysis—to changes in relative prices. The dramatic jumps in oil prices in 1973-74 and again in 1979-80 are the major example. Those price trends could then be related to observed productivity growth. Our econometric model determines the growth of sectoral productivity as a function of relative prices of sectoral inputs. We allow for the fact that the value of sectoral output includes the value of intermediate inputs—energy and materials—as well as the value of primary factors of production—capital and labor. Differences in relative prices for inputs are associated with differences in productivity growth for each sector.

Q. What conclusions did this analysis lead to?
A. After analyzing productivity growth for 35 individual industrial sectors we found that productivity growth decreases with an increase in the price of capital input for a very large proportion of U.S. industries. Similarly, productivity growth falls with higher prices of labor input for a large proportion of industries. The impact of higher energy prices is also to slow the growth of productivity for a large proportion of industries. By contrast we found that an increase in the price of materials input is associated with increases in productivity growth for almost all industries.

Q. What about the collapse of productivity growth after 1973?
A. We found that the collapse of productivity

growth at the sectoral level was a consequence of the sharp increase in the price of energy relative to other productive inputs that began with the run-up of world petroleum prices in late 1973 and early 1974. The fall in sectoral productivity growth after 1973 is responsible in turn for the decline in productivity growth for the U.S. economy as a whole. This led to the major conclusion: slower productivity growth is the primary source of the slowdown in U.S. economic growth since 1973.

Q. In telling your story about the causal link from energy prices to the decline in productivity, you explicitly consider complementary and substitution relationships between the factors of production.

A. Yes, these are very important. As energy prices increase, producers have an incentive to use less energy. We found in examining these relations among 35 industries, that as producers use less energy in response to rising energy prices, they also cut back on the use of capital. Capital and energy are used in complementary fashion in many industries. In contrast, energy and employment of labor appear to be substitutes. While a rise in energy prices cuts the use of both energy and capital inputs, the demand for labor rises. The complementary relationships between energy and capital use helps to fill in our story about the rise in energy prices causing a slowdown in capital formation and productivity growth.

Q. If increases in the prices of capital and of energy depress productivity growth, doesn't an increase in the wage rate also depress productivity growth?

A. Exactly. What it suggests is this. Since in 1979 we have an even larger increase in domestic energy prices than we had in 1973 and '74—because we're in the process of decontrolling oil prices—we can expect a further downturn in the growth of potential GNP. The only thing we can do to offset that is to reduce the effective tax rate on capital and labor. The case for a payroll tax cut is just as strong as the case for a capital tax cut. In a tax package I would give equal weight to the two. The analysis that we've done on productivity change provides a rationale for this balanced approach: The substitution and complementary effects of rising energy prices otherwise say why not go all the way for productivity by stimulating the growth of capital. But that in our view is only 50 percent of the truth.

Q. But let's focus now on the capital component of your tax package. Just what do you propose?

A. In any attempt to promote investment, there are two elements of our policy strategy: One is to increase the capital-labor ratio by strengthening investment incentives through a cut in the effective tax on capital. The other is to sustain rapid growth in aggregate output—that is, to operate as close to potential GNP as possible. Both elements are essential. It is possible to improve investment incentives with tax cuts, but still fail to generate new capital formation, because deficient aggregate demand and excessive unemployment dampens the expected returns on new investment. Together, growth in aggregate demand and new tax incentives will produce a very substantial investment response.

Q. The kind of tax cut is critically important in your view, isn't it?

A. Precisely. The Auerbach-Jorgenson proposal—a First Year Capital Recovery System (FYCRS)—is based on the recovery of capital consumption during the year an asset is acquired. This would insulate capital consumption allowances from the effects of inflation or variations in the rate of inflation. The FYCRS—unlike alternatives such as the popular Conable-Jones "10-5-3" system proposed in Congress—could cope with high, moderate and low rates of inflation without introducing the distortions resulting from the current tax system. Our system would permit taxpayers to deduct the present value of economic depreciation as an expense in arriving at income for tax purposes. To avoid the erosion of the value of capital consumption allowances with inflation, the present value of economic depreciation is allowed as a deduction in the same year that an asset is acquired. Future economic depreciation must be discounted back to the present to arrive at a present value of economic depreciation over the life of the capital good.

Q. Could you give a concrete example?

A. Certainly. The present value of one dollar's worth

of investment in a long-lived asset such as a manufacturing plant might be 50 cents. For a short-lived asset such as a pick-up truck, the present value of one dollar's worth of investment might be 75 cents. An investor would be allowed to deduct against his business income the present discounted value of the economic depreciation by class of capital goods in the same year in which the asset was purchased. If you bought a long-lived shopping center or a hotel, you might deduct fifty cents on the dollar. Buying shorter lived capital goods such as industrial machinery, maybe a locomotive, would provide, say, a 75 cent deduction on the dollar. A computer purchase maybe 80 cents on the dollar. The 50, 75, and 80-cent deductions reflect the different lifetimes of capital assets.

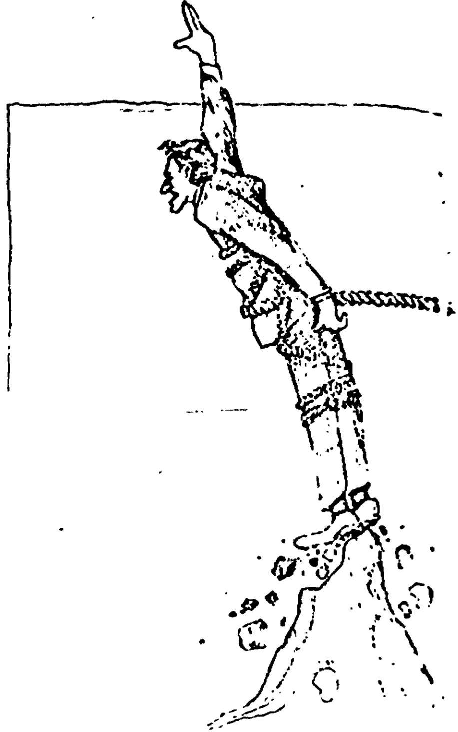
Q But exactly why is it important to use the present value of these assets in this system?
A. Since capital goods have quite different lifetimes, and since income, net of inflation, must reflect the fact that economic depreciation occurs over time, you have to convert it to a present value by time discounting. This enables you to produce effective tax rates that are the same across all assets, whether these assets have short lives or long lives. As a result, the FYCRS avoids the distortions in the allocation of investment that result from the impact of inflation on effective rates of taxation in the current tax system. Under current law, inflation results in a heavier tax burden on all assets. The distortion in investment allocation arises because current tax law imposes a greater effective tax burden on long-lived structures than on business equipment. Therefore incentives to purchase equipment are greater than incentives to purchase structures. Our proposal, based on deduction of the present value of economic depreciation in the year an asset is purchased, would eliminate this bias in the allocation of investment funds. Our research shows that aggregate output from the existing capital stock could be increased by shifting its composition away from equipment toward structures. We need a system that imposes equal effective tax rates on all assets, regardless of their lifetimes. FYCRS provides that major advantage.

Q. Do you see other important advantages?
A. Yes, in particular, FYCRS would bring a substantial cut in business paperwork, which is a heavy burden for small business especially. Our tax proposal would enable taxpayers to dispense with cumbersome systems of capital accounts for tax reporting purposes. No records of past purchases would be required to substantiate consumption allowances taken in a given year. Taxpayers would no longer have to choose among a range of asset lifetimes and alternative depreciation formulas to compute their taxes. They would simply apply the first-year purchases of depreciable plant and equipment.

Q. While your tax proposal is impressive in theory, what makes you so confident that it would invigorate capital formation in the United States in the 1980s? What evidence do you see?
A. First of all, look at the historical experience and the way accelerating inflation raised the effective tax rates on capital assets. Before 1954, effective tax rates on structures were in line with the statutory rate on corporate income of 52 percent. Effective tax rates on equipment, however, far exceeded statutory rates. Accelerated depreciation adopted in 1954 reduced the effective rates on both structures and equipment, but effective rates on equipment still remained above statutory rates until adoption of the guideline lifetimes and the investment tax credit in 1962. The repeal of the Long Amendment in 1964 further reduced effective rates on equipment to levels well below the statutory rate. These tax reductions by the early 1960s brought about a tremendous investment boom. Within a period of about four years the level of investment increased something like 40 percent, while GNP rose maybe 20 percent. This produced a tremendous increase in the capital output ratio.

Q. What happened to those tax cuts?
A. They were undone largely by the acceleration of inflation rates to double digits of the present day. As the pace of inflation quickened during the late 1960s the effective tax rates of equipment rose gradually; repeal of the investment tax credit in 1969 raised effective tax rates to levels comparable to those that had prevailed before 1962. Similarly, inflation and restriction of accelerated depreciation on structures to the 150 percent declining balance method after 1966 resulted in increases in the effective tax rates for structures to levels that exceeded those that prevailed before 1954. Reinstitu-

tion of the investment tax credit for equipment in 1970, adoption of the Asset Depreciation Range system in 1971, and the increase in the rate of the credit from seven to ten percent resulted in effective tax rates well below the statutory rate, even in the face of double-digit inflation in 1973 and again in 1979.



Q. You did a computer simulation, in which the FYCRS was phased in over five years, beginning in 1981. What did that experiment suggest about the response of investment to more favorable tax treatment?

A. Our research shows that the First Year Capital Recovery System provides a very substantial stimulus to capital formation. Within five years after the adoption of the new system, real investment in equipment would increase by $6.0 billion and real investment in nonresidential structures would increase by $9.1 billion. The greater relative stimulus to investment in structures is the result of removing the distortions between capital consumption allowances and economic depreciation that exist under current law. Although there would be no specific incentive to owner-occupied housing, real investment in residential structures would increase by $2.3 billion within five years.

Q. What about the impact on unemployment?

A. With substantial unemployment in prospect through 1985, the stimulus to investment provided by the First Year Capital Recovery System would result in an increase in real gross national product of $14.5 billion by 1984. The unemployment rate in 1984 would be reduced by three-tenths of a percentage point from a level near 7 percent that would prevail in the absence of stimulus to capital formation. The increase in the rate of inflation, as measured by the deflator of gross national product, would increase by two-tenths of a percentage point per year by 1984.

Q. Would this tax cut throw the federal budget into chaos?

A. Our research results suggest a total revenue loss of $50.9 billion over the first five years of adoption of the First Year System. Thus, adoption of the First Year Capital Recovery System would provide a very sizable stimulus to capital formation at the cost of a modest revenue loss to the federal government. It would also contribute to the reallocation of the capital stock from equipment toward structures in order to rectify the misallocation of capital that has resulted from current tax law. By enhancing the efficiency of the use of capital, the First Year System would assure that additional capital formation would have maximum impact on productivity and economic growth.

Q. Let's put this discussion of productivity issues into a larger global context now and relate it to the popular debate on the reindustrialization of America. Some observers have criticized American industry for lagging behind in applying new technology in comparison with the Japanese and German performance. If we just introduce some tax proposal like yours to decrease the cost of capital, how will we be sure that industries will not simply invest in relatively obsolete capital or technology?

A. With respect to spurring technological innovation, the greatest possible benefit would result

from a high degree of international competition. In other words, I believe that the attempts to close the U.S. steel market, for example, by means of a trigger price system was an unmitigated catastrophe —that was just a guarantee for firms like U.S. Steel and Bethlehem that provided an incentive to accumulate capacity that would later turn out to be an international white elephant.

Q. Yet this view of open international competition, so typical of most academic economists, is not very palatable to many members of Congress, businessmen, and labor leaders. Many fear that opening up domestic markets to foreign imports would bring mass unemployment. They cite unemployment in the U.S. auto industry in the face of Japanese imports as a prominent example. But as you see, this raises the question of industrial policy again—the adjustment policy that we have in place to move resources out of the declining ind stries into the more efficient expanding industries. How do you view that whole problem?

A. Well, the current situation results from a concatenation of mistakes. The Carter administration made a fundamental error in October of 1979 and again this March of trying to cool off inflation by means of a monetary crunch as opposed to a slowdown in the growth of the money supply.

Q. Didn't that bring back positive real interest rates?
A. Yes, it brought back positive real interest rates but I don't view that as a great gain because of the economic disorganization that resulted. As you point out, the crisis in the auto industry in particular made the monetary crunch very painful politically.

Q. Do you think the automobile industry's problems are a result of the monetary crunch in March?
A. No, no. I think the nationwide increase in unemployment that we have experienced is a result of the monetary crunch that we began in October and was aggravated in March. There's absolutely no reason why we would have had to have an increase in

the unemployment rate from the sixes up to whatever we have now—7.4, 7.6 percent. That percentage-and-a-half increase in the rate of unemployment was the consequence of a misguided policy by the Carter administration which mistakenly assumed that it was possible to solve the problem of inflation overnight. Now, let's go back to the situation in October. If we had a 6 percent unemployment rate and Japanese imports undermined the market for automobiles, those workers would find employment opportunities within other industries. There would be an adjustment problem; there's no question about it.

Q. What do we do about that adjustment problem?
A. What I'm saying is that we produce new jobs not by trying to close out imports and trying to hold on to jobs in the industries where the unemployment has occurred. The problem is to get those people to move out of industries like autos and into other growing industries. You're not going to do that if you have a countercyclical policy which creates an unemployment of a percentage-and-a-half of the labor force during a period when we need a tight labor market in order to make long-term adjustments. Our countercyclical policy was completely misguided. That is the root cause of the political pressure that has caused some people to attack a desirable free-trade policy which accompanies a restructuring of the U.S. economy. Open, free trade is not the root cause of our problem. The root cause is the intentional creation of unemployment in a misguided hope that it could somehow slow down the inflation rate.

Q. So you see this problem mainly as a collapse of aggregate demand caused by misguided monetary restraint. But I think some others, at least in the automobile industry, see it as a shift in consumer purchases from large to small cars, the latter being imports.
A. It was the shift in consumer purchases towards smaller cars, and to Japanese cars in particular, which was aggravated by growing unemployment in the housing industry and in other industries which had nothing to do with Japanese competition. If we had avoided the rise in the unemployment rate above 6 percent, the structural changes could have proceeded in a more orderly way. There would have been some people on trade adjustment assistance—extended unemployment compensation—but some would have moved and got jobs elsewhere. In my view, our macroeconomic policy has been completely ill-advised and now we're having to pay the tab. Unfortunately, we have undermined a long-standing policy of opening up our markets to the competition of international trade. If we had a more open economy, that would help bring about the structural readjustment we need.

Q. Isn't it conceivable that American industry in time will produce smaller, more efficient cars of higher quality to meet the challenge from abroad? Can't the U.S. producers regain their lost market shares?
A. No, I don't think so. I think there's a permanent loss in market share. The Japanese really have a role to play in the American marketplace. But, you're right to some extent. The market for cars in general is temporarily depressed. The American industry is certainly not going to remain at its current depressed levels. There are going to be some of those jobs coming back, but nonetheless there are various estimates that between a quarter and a half a million jobs in the automobile industry and associated industries—parts, rubber and so on—are permanently lost. Those people have to find work elsewhere. The idea that shutting off imports can somehow ease the pain is a misguided approach.

Q. How would we deal with these structural problems then?
A. The only way we can deal with U.S. Steel, Chrysler, Ford, and the other corporations which make inappropriate decisions and mistakes is to let them pay the market's price in lost profits, lost capacity to produce, and lost jobs. In the economy as a whole we've got to maintain a tight labor market to avoid imposing the burden on the wrong people. There's no reason why the labor force in contracting industries ought to be bearing the major burden. Therefore, we ought to have trade adjustment assistance, but we ought to make sure that there's no incentive to keep these people hanging around when they should be moving out into more dynamic industries.

Q. So you really want to discipline business

enterprise according to the rewards and punishments of the market mechanism?
A. Yes, and we have to because we're in a situation where the U.S. economy is opened up more to international trade, where it's a much more competitive situation internationally, where relative exchange rates are adjusting to a completely new situation since the Smithsonian agreement, the energy crisis, and so on. And we have to place more reliance on the price system as an adjustment mechanism.

Q. Yet, members of Congress, when they discuss the problem of structural adjustment, see it as a very human problem. We economists talk about moving people from Detroit to the western United States to take jobs assembling computers. But these workers need retraining. They need support for their families, help in moving and relocating. This implies a full range of social services to foster geographic shifts and economic adjustment. It requires more than simply unemployment compensation.
A. You're absolutely right. It requires unemployment compensation, trade adjustment assistance, retraining, but most important, economic growth and a tight labor market. Now, in addition to the aggregate demand approach, remember that I advocate reducing payroll taxes. Reducing payroll taxes provides an added incentive to employ people. This increases the tension in the labor market and pulls people to new opportunities.

Q. Elsewhere you've written about this problem of structural adjustment—particularly the ongoing adjustment to higher energy prices—and you have mentioned a "blind spot" in the outlook of our policy-making institutions. What do you mean?
A. Wow, that's a tough one. What do I mean by a blind spot? When I studied the role of rising energy prices in the American economy, I noted their impact hit over a period of from two to five years. In the time horizon of our policy-making bodies that seemed to be a blind spot between the annual process organized around Congressional enactment of the budget with a one-to-two-year outlook and the long-run assessment of a balance between social and military spending, say, or the allocation of the national product between the public and private sectors.

Q. Are there any agencies which systematically look beyond the one-to-two-year policy horizon? What can we do with our policy-making institutions to correct for the blind spot?
A. There's going to have to be some major institutional innovation. I'm not prepared to say what the nature of that is going to be. But our current institutions are completely incapable of coping with this problem. Therefore I think the idea that we're going to have a real revitalization, or reindustrialization program, without a major institutional change is a delusion. I'm not optimistic about what all this is going to come to.

Q. How do you respond to some economists and members of Congress who believe a long-range perspective on economic policy requires some type of planning?
A. Well, I wouldn't be very sympathetic to that idea. In the American context that would be difficult to square with our institutions. The models that are often taken for planning—indicative planning in France, MITI (the Ministry for International Trade and Industry) in Japan—were appropriate in much different circumstances and most important for a much smaller economy emerging from a disastrous war. The blind spot I see is in the planning by the federal government of its own activities which, you know, are 20 to 25 percent of the GNP. There the whole focus is on the budgetary cycle—the next twelve to twenty-four months. What is really needed is a longer-term budgetary process, with planning for appropriations over, say, five years.

Q. So we're left, then, with your option for relying more on the market mechanism and allowing prices to signal the movement of resources as quickly as possible. Yet we seem to have forces operating in our economic system which tend to make the price structure more rigid, which undermine the operation of the price system as an allocating device.
A. That's true. But consider one hopeful sign. The decontrol of petroleum prices, in my opinion, is the most important policy change that occurred during the Carter administration. Decontrol will be

completed by October 1981. Energy prices were completely out of kilter with the opportunity costs of the world market until decontrol became part of energy policy in May 1979. So it's not enough to say that you know you want to use the price system; you also have to take steps to get the prices right. Certainly, the cheap and economical way to promote conservation was to get the prices right.

Q. Isn't there an analogous problem in the capital markets?
A. Exactly the same situation obtains in the market for capital. Right now nobody could claim that a market solution for the allocation of capital makes any sense. Why? Because the tax structure does not in fact produce the conditions that are needed to make the market work—namely, equal effective tax rates for all different kinds of capital. So you could compensate for deficiencies in the tax system by a system of planning in which we would attempt to compensate for the errors private investors make because of distortions in effective tax rates. But it would be simpler and cheaper to reform the tax structure.

Q. So, summing up then, planning for a more effective market mechanism would be your approach to long-term planning or coordination.
A. Exactly, precisely.

Q. What about the contribution of technology change to productivity performance? Some economists are increasingly concerned with the outlook for technology change and innovations which they believe give major impetus to productivity improvement. Would you propose any policy mechanisms for promoting technology change, or research and development in the public and private sectors?
A. Yes, I guess that there are some things that represent changes that I would approve. We have to remember now that research and development are something that is favored by such market mechanisms as we have. This results from the fact that R&D expenses are completely deductible from income for tax purposes. Yet many of the benefits of R&D are spread out over time—and therefore, like fixed capital, really depreciate over time—and so ought to be expensed only in part. Nonetheless, I wouldn't favor making a change in that direction at this point.

Q. If the tax treatment of R&D is not an obstacle, then where does the problem arise?
A. Well, in my view there are two problems. One is the venture capital problem. What do we do to encourage the MIT professor who is working in his garage on the next generation of some electronic device for producing computers? Well, what we ought to do is what the Congress has already done. They have, as you know, sponsored the formation of the so-called SBICs—Small Business Investment Corporations—which can borrow money, up to 80 percent, from the Small Business Administration at subsidized government interest rates and lend that out to venture capitalists with 20 percent equity participation by real venture capitalists. The result was an explosion of SBICs. There were only 50 or 60 of them until a few years ago and now there are something like 300. In Boston, for example, you can find all kinds of these things—you can invest in them, you can go to them and get funds.

Q. So this is a government program that actually resulted in a new flow of capital.
A. Yes, a new flow of venture capital administered by the Small Business Administration. So I regard this as a tremendously desirable thing. The real problem that still remains is the link between science and technology. Most of the so-called basic research is supported by agencies that are effectively controlled by their clientele. The National Science Foundation, for example, is run essentially by scientists for the benefit of scientists. Now, despite what people say about the great benefits of that, there is no mechanism to link the scientific work directly to the needs of the business sector for new technology.

Q. So the problem is to translate new science into new, effective economic technology?
A. Exactly. And that is a very important missing link. It's the development side. Now what is really needed is a more effective link between the universities and business. Ralph Landau, chairman of Halcyon Corporation, has suggested some kind of tax credit for business support of university research. That means we're talking about engineering research, we're talking about MIT, Cal Tech, the University of California at Berkeley, Stanford, and so

on, as opposed to Harvard.

Q. What about the declining share of U.S. science in global scientific endeavors? Are we losing pace relative to other countries?
A. Yes. The market share of the U.S. scientific community in overall world science has decreased, you know, in publications or other measures of scientific output, such as patents, from about 70 percent, say, in the fifties to roughly 50 percent today.

Q. What are implications of that decline?
A. Half of the research that could be applicable to technological developments in the United States is being done outside the United States. There is completely inadequate attention to this. There's inadequate language training for scientists here. How many American physicists or economists can read Japanese or Russian to keep up on developments abroad?

Q. Yet aren't our colleges and universities cutting back on their foreign languages programs?
A. Exactly. And that's exactly the wrong thing to do.

Q. Well, what's the alternative?
A. Well, maybe changing the character of higher education by language training at the universities. The government could support language training for scientists and engineers to learn Japanese, Russian, or even German on a full-time basis for, say, a half-year.

Q. But isn't part of the problem rooted in demographics? Student enrollments are declining, graduate programs and faculties are contracting.
A. Oh, yes, that's a very serious problem. The faculties are growing older and you're not producing the quantities of younger scholars who generate a lot of the new ideas and research. The critical problem is the expansion in the engineering and the more applied end of university-based science and technology.

Q. How does your story about the rise of energy prices and the collapse of productivity growth tie in with research and development?
A. Here I would agree with Denison's emphasis on the innovation process. The change in relative prices, particularly energy, has altered the character of productivity growth and thereby the underlying innovation process. The whole process has faltered and slowed down. Ever since the industrial revolution, human efforts have been oriented toward the simple mechanism of substituting capital for labor. Now we're confronted with a change in relative prices that causes concern about energy conservation. At the same time science and technology, as well as our capital stock, have been rendered virtually obsolete. In addition, the evolutionary process of scientific research and technology development has been slowed by the demographic situation facing U.S. universities. Many careers and many generations of scientists were oriented towards a world with relatively inexpensive energy. The rise in energy prices must move scientific progress in a completely new direction. That's a worldwide problem because the Japanese, the Russians, and the Germans are facing exactly the same energy situation we are.

Q. Won't the change in relative price itself motivate research and development in the appropriate direction?
A. It will motivate new technology, but the whole process will be very slow to respond to these new opportunities for taking advantage of the changes in relative prices. Most of these scientific decisions —new projects which will be undertaken, the character of training and the curriculum—all that takes place outside the market system. And therefore it requires specific measures that would redirect research, redirect training to reflect the new situation. Now that is precisely where we need to establish this link of the scientific apparatus to the business sector. You've got to bring the engineers at General Motors more closely into contact with their counterparts in the universities. You have to bring university engineers more closely into contact with their counterparts in the basic research end of engineering. The engineers in basic research must be in contact with the people who are doing basic research in the fundamental disciplines—mathematics, physics, chemistry, and so on. And all of those links are going to have to be strengthened. Weakness in any one could slow down the whole process.

TAXATION AND TECHNICAL CHANGE

by

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TAXATION AND TECHNICAL CHANGE

by

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I. Introduction

The growth of the U.S. economy in the postwar period has been very rapid by historical standards. The rate of economic growth reached its maximum during the period 1960 to 1966. Growth rates have slowed substantially since 1966 and declined further since 1973. A major source of uncertainty in projections of the future of the U.S. economy is whether patterns of growth will better conform to the rapid growth of the early 1960's, the more moderate growth of the late 1960's and early 1970's or the disappointing growth since 1973.

The purpose of this paper is to consider the prospects for restoring moderate economic growth through tax policy. For this purpose we decompose the growth of output during the postwar period into contributions of capital input, labor input, and the rate of technical change. For the period 1948 to 1976 we find that all three sources of economic growth are significant and must be considered in analyzing future growth potential. For the postwar period capital input has made the most important contribution to the growth of output, technical change has been next most important, and labor input has been least important.

Focusing on the period 1973 to 1976, we find that the fall in the rate of economic growth has been due to a dramatic decline in the

rate of technical change. Declines in the contributions of capital and labor input are much less significant in explaining the slowdown. We conclude that the future development of technology should be the primary focus of efforts to stimulate future U.S. economic growth.

Given the importance of technical change in future economic growth we attempt to analyze the slowdown in the rate of technical change for the U.S. economy as a whole in greater detail. For this purpose we decompose technical change during the postwar period into components that can be identified with technical change at the sectoral level and with reallocations of output, capital input, and labor input among sectors. For the period 1948 to 1976, we find that these reallocations are insignificant relative to sectoral technical change. The combined effect of all three reallocations is slightly negative, but sufficiently small in magnitude to be negligible as a source of aggregate technical change.

Again focusing on the period 1973 to 1976, it is possible that the economic dislocations that accompanied the severe economic contraction of 1974 and 1975 could have resulted in shifts of output and inputs among sectors that contributed to the slowdown of the aggregate rate of technical change. If this were true, then economic policy should be focused on reallocation of output among sectors. This appears to be the objective of industrial revitalization programs, such as the program proposed by the Carter Administration. Alternatively, sources of the slowdown in the aggregate rate of technical change might be found in falling rates of technical change at the level of individual industrial sectors. In

this case the objective of economic policy should be to stimulate the development of new technology for all industrial sectors.

We find that reallocations of output and inputs among sectors made positive rather than negative contributions to economic growth during the period 1973-1976. Economic policies oriented toward revitalization of the economy by reallocating economic activity among industries appear to be misguided. We conclude that declines in rates of technical change for the individual industrial sectors of the U.S. economy must bear the full burden of explaining the slowdown in the rate of technical change for the economy as a whole. The major focus for economic policy should be to stimulate the development of new technology for all industries.

To identify policies that can stimulate the development of new technology we present the results of an econometric analysis of the eterminants of productivity growth at the sectoral level. Our econometric model determines the growth of sectoral productivity as a function of relative prices of sectoral inputs. For each sector we divide inputs among capital, labor, energy, and materials inputs. We allow for the fact that the value of sectoral output includes the value of intermediate inputs -- energy and materials -- as well as the value of primary factors production -- capital and labor. Differences in relative prices for inputs are associated with differences in the rate of technical change for each sector.

After fitting our econometric model of productivity growth to data for individual industrial sectors we find that rate of technical change decreases with an increase in the price of capital input for a very large proportion of U.S. industries. Similarly, the rate of technical change falls with higher prices of labor input for a large proportion of industries. The impact of higher energy prices is also to slow the rate of technical change for a large proportion of industries. By contrast we find that an increase in the price of materials input is associated with increases in rates of technical change for almost all industries.

Tax policies over the postwar period have resulted in wide variations in effective rates of taxation on income from corporate capital. Effective tax rates at the beginning of the postwar period were less than seventy percent of the statutory rate of thirty-eight percent. Tax rates rose to almost eighty percent of the higher statutory rate of fifty-two percent over the period from 1953 to 1961. Beginning in 1962, a series of tax reforms resulted in a steady decline in effective tax rates through 1965. For some assets the effective tax rate on corporate capital was reduced by more than half. Effective tax rates rose sharply from 1965 to 1970 and fell over the period from 1970 to 1972. Effective tax rates were reduced substantially in 1975, reached a postwar minimum in 1977 and have risen since then.

Examining the postwar development of technology for the economy as a whole, we find that technical change attained its maximum during the period 1960-1966, when effective rates of taxation on income from corporate capital were falling. During the period 1966-1969, when effective rates were increasing dramatically, the rate of technical change declined to the lowest level in the postwar period up to 1969. The rate of technical change recovered to levels close to the postwar average during the period 1969-1973, when effective tax rates were falling.

Since 1973 the relative prices of capital, labor, energy, and materials inputs have been altered radically as a consequence of the increase in the price of energy relative to other productive inputs. Higher world petroleum prices following the Arab oil embargo of late 1973 and 1974 have resulted in sharp increases in prices for all forms of energy in the U.S. economy -- oil, natural gas, coal, and electricity generated from fossil fuels and other sources. Although the U.S. economy has been partly shielded from the impact of higher world petroleum prices through a system of price controls, all industrial sectors have experienced large increases in the price of energy relative to other inputs.

Our econometric model reveals that slower productivity growth at the sectoral level is associated with higher prices of capital and energy relative to other inputs. Our first conclusion is that the pattern of increases and decreases in the aggregate rate of technical change over the postwar period is inversely correlated with changes in the price

effective rate of taxation on capital. High effective rates of taxation are associated with low rates of technical change, while low effective tax rates are associated with high rates of technical change.

Our second conclusion is that the slowdown in sectoral rates of technical change since 1973 is at least partly due to the sharp increase in the price of energy relative to other productive inputs. This increase began with the run-up of world petroleum prices in late 1973 and early 1974. The fall in sectoral rates of technical change after 1973 is responsible in turn for the decline in ther ate of technical change for the U.S. economy as a whole. Slower technical change is the primary source of the slowdown in the U.S. economic growth since 1973.

During 1979 and early 1980 world petroleum prices have jumped 130 to 140 percent, following the Iranian revolution of late 1978. Since the outbreak of the Iran-Iraq War in 1980, spot petroleum prices have begun to increase relative to the higher levels established in 1979 and early 1980. Based on the performance of the U.S. economy since 1973, we can anticipate a further slowdown in the rate of economic growth, a decline in the rate of technical change for the economy as a whole, and declines in sectoral rates of technical change for a wide range of industries.

To offset the drag on the development of new technology for the U.S. economy as a whole due to higher energy prices, it is important to take immediate steps to reduce the effective rate of taxation on capital and labor. Reduction in effective tax rates on capital has been thoroughly tested as a policy instrument for stimulating technical change. For this purpose we propose a new approach to capital recovery under tax law that would counteract the effects of higher energy prices.

2. The Growth Slowdown

In this section we begin our analysis of the slowdown in U.S. economic growth by decomposing the growth of output for the economy as a whole into the contributions of capital input, labor input, and technical change.[1] The results are given in Table 1 for the postwar period 1948-1976 and for the following seven subperiods -- 1948-1953, 1953-1957, 1957-1960, 1960-1966, 1966-1969, 1969-1973, and 1973-1976.[2] Except for the period from 1973 to 1976, each of the subperiods covers economic activity from one cyclical peak to the next. The last period covers economic activity from the cyclical peak in 1973 to 1976, a year of recovery from the sharp downturn in economic activity in 1974 and 1975.

We first present rates of growth for output, capital input, labor input, and the rate of technical change for the U.S. economy. For the postwar period as a whole output grew at 3.50 percent per year, capital input grew at 4.01 percent, and labor grew at 1.28 percent. The rate of technical change averaged 1.14 percent per year. The rate of economic growth reached its maximum at 4.83 percent during the period 1960-1966 and grew at only 0.89 percent during the recession and partial recovery of 1973-1976. The growth of capital input was more even, exceeding 5 percent in 1948-1953 and 1966-1969 and falling to 3.12 percent in 1973-1976. The growth of labor input reached its maximum in the period 1960-1966 at 1.99 percent and fell to 0.58 percent in 1973-1976, which was above the minimum of 0.23 percent in the period 1953-1957.

Table 1

GROWTH OF OUTPUT AND INPUTS FOR THE
U.S. ECONOMY, 1948-1976

	1948-1976	1948-1953	1953-1957	1957-1960	1960-1966	1966-1969	1969-1973	1973-1976
Growth Rates:								
Output	0.0350	0.0457	0.0313	0.0279	0.0483	0.0324	0.0324	0.0089
Capital Input	0.0401	0.0507	0.0393	0.0274	0.0376	0.0506	0.0396	0.0312
Labor Input	0.0128	0.0160	0.0023	0.0099	0.0199	0.0185	0.0116	0.0058
Rate of Technical Change	0.0114	0.0166	0.0146	0.0113	0.0211	0.0004	0.0095	-0.0070
Contributions:								
Capital Input	0.0161	0.0194	0.0154	0.0109	0.0156	0.0211	0.0161	0.0126
Labor Input	0.0075	0.0097	0.0013	0.0057	0.0116	0.0108	0.0068	0.0033

We can express the rate of growth of output for the U.S. economy as a whole as the sum of a weighted average of the rates of growth of capital and labor inputs and the rate of technical change. The weights associated with capital and labor inputs are average shares of these inputs in the value of output. The contribution of each input is the product of the average shares of this input and corresponding input growth rate. We present contributions of capital and labor inputs to U.S. economic growth for the period 1948-1976 and for seven subperiods in Table 1. Considering technical change, we find that the maximum rate occurred from 1960 to 1966 at 2.11 percent per year. During the period 1966-1969 the rate of technical change was almost negligible at 0.04 percent. The rate of technical change recovered to 0.95 percent during the period 1969-1973 and fell to a negative 0.70 percent during 1973-1976.

Since the value shares of capital and labor inputs are very stable over the period 1948-1976, the movements of the contributions of these inputs to the growth of output largely parallel those of the growth rates of the inputs themselves. For the postwar period as a whole the contribution of capital input of 1.61 percent is the most important source of output growth. Technical change is next most important at 1.14 percent, while the contribution of labor input is the third most important at 0.75 percent. All three sources of growth are significant and must be considered in an analysis of the slowdown of economic growth during the period 1973-1976. However, capital input is clearly the most important contributor to the rapid growth of the U.S. economy during the postwar period.[3]

Focusing on the period 1973 to 1976, we find that the contribution of capital input fell to 1.26 percent for a drop of 0.35 percent from the postwar average, the contribution of labor input fell to 0.33 percent for a drop of 0.42 percent, and that the rate of technical change at a negative 0.70 percent dropped 1.84 percent. We conclude that the fall in the rate of U.S. economic growth during the period 1973-1976 was largely due to the fall in the rate of technical change. Declines in the contributions of capital and labor inputs are much less significant in explaining the slowdown. A detailed explanation of the fall in the rate of technical change is needed to account for the slowdown in U.S. economic growth.

To analyze the sharp decline in the rate of technical change for the U.S. economy as a whole during the period 1973 to 1976 in greater detail we employ data on rates of technical change for individual industrial sectors. For this purpose it is important to distinguish between technical change at the aggregate level and technical change at the sectoral level. At the aggregate level the appropriate concept of output is value added, defined as the sum of the values of capital and labor inputs for all sectors of the economy. At the sectoral level the appropriate concept of output includes the value of primary factors of production at the sectoral level -- capital and labor inputs -- and the value of intermediate inputs -- energy and materials inputs. In aggregating over sectors to obtain output for the U.S. economy as a whole the production and consumption of intermediate goods cancel out, so that values of energy and materials inputs do not appear at the aggregate level.

We can express the rate of technical change for the U.S. economy as a whole as the sum of four components. The first component is a weighted sum of rates of technical change for individual industrial sectors. The weights are ratios of the value of output in each sector to value added in that sector. The sum of these weights over all sectors exceeds unity, since technical change in each sector contributes to the growth of output in that sector and to the growth of output in other sectors through deliveries of intermediate inputs to those sectors. The remaining components of aggregate technical change represent the contributions of reallocations of value added, capital input, and labor input among sectors to technical change for the economy as a whole.[4]

The role of reallocations of output, capital input and labor input among sectors is easily understood. For example, if capital input moves from a sector with a relatively low rate of return to a sector with a high rate of return, the quantity of capital input for the economy as a whole is unchanged, but the level of output is increased, so that productivity has improved. Similarly, if labor input moves from a sector with low wages to a sector with high wages, labor input is unchanged, but productivity has improved. Technical change for the economy as a whole is a combination of improvements in technology at the sectoral level and reallocations of output, capital input and labor input among sectors. Data on reallocations of output, capital input, and labor input for the postwar period 1948 to 1976 and for seven subperiods are given in Table 2.[5]

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Table 2

THE RATE OF TECHNICAL CHANGE FOR THE U.S. ECONOMY
1948-1976

	1948-1976	1948-1953	1953-1957	1957-1960	1960-1966	1966-1969	1969-1973	1973-1976
Sectoral Rates of Technical Change:	0.0124	0.0219	0.0177	0.0145	0.0217	0.0025	0.0048	-0.0113
Reallocation of Value Added:	-0.0016	-0.0075	-0.0030	-0.0010	-0.0016	-0.0025	0.0030	0.0046
Reallocation of Capital Input:	0.0008	0.0022	0.0008	-0.0001	0.0002	0.0001	0.0010	0.0008
Reallocation of Labor Input:	-0.0002	-0.000	-0.0008	-0.0021	0.0008	0.0004	0.0006	-0.0011

For the postwar period as a whole technical change at the aggregate level is dominated by the contribution of sectoral technical change of 1.24 percent per year. The contributions of reallocations of output, capital input, and labor input are a negative 0.16 percent, a positive 0.08 percent, and a negative 0.02 percent. Adding these contributions together we find that the combined effect of the three reallocations is a negative 0.10 percent, which is negligible by comparison with the effect of technical change at the sectoral level. The rate of technical change at the aggregate level provides an accurate picture of average rates of technical change for individual industries; this picture is not distorted in an important way by the effect of reallocation of output and inputs among sectors.

Again focusing on the period 1973-1976, we find that the contribution of sectoral technical change to technical change for the economy as a whole fell to a negative 1.13 percent for a drop of 2.37 percent from the postwar average. By contrast the contribution of reallocations of output rose to 0.46 percent for a gain of 0.62 percent from the postwar average. The contribution of the reallocation of capital input was unchanged at 0.08 percent, while the contribution of labor input fell to a negative 0.11 percent for a drop of 0.09 percent from the postwar average. The combined contribution of all three reallocations rose 0.53 percent, partially offsetting the precipitous decline in rates of technical change at the sectoral level. We conclude that declines in rates of technical change for the individual industrial sectors of the U.S

economy are more than sufficient to explain the decline in the rate of technical change for the economy as a whole.

To summarize our findings on the slowdown of U.S. economic growth during the period 1973-1976, we find that the drop in the growth of output of 2.61 percent per year from the postwar average is the sum of a decline in the contribution of labor input of 0.42 percent per year, a sharp dip in sectoral rates of technical change of 2.37 percent, a rise in the role of reallocations of output among sectors of 0.62 percent per year, no change in the reallocations of capital input, and a decline in the contribution of reallocations of labor input of 0.09 percent per year. Whatever the causes of the slowdown, they are to be found in the collapse of technical change at the sectoral level rather than a slowdown in the growth of capital and labor inputs at the aggregate level or the reallocations of output, capital input, or labor input among sectors.

The decomposition of economic growth into the contributions of capital input, labor input, and the rate of technical change is helpful in pinpointing the causes of the slowdown. The further decomposition of technical change for the economy as a whole into contributions of sectoral rates of technical change and reallocations of output, capital input, and labor input is useful in providing additional detail. However, our measure of the sectoral rate of technical change is simply the unexplained residual between growth of sectoral output and the contributions of sectoral capital, labor, energy, and materials inputs. The problem remains of providing an explanation for the fall in rates of technical change at the sectoral level.

3. Sectoral Rates of Technical Change

We have now succeeded in identifying the decline in the rate of technical growth at the level of individual industrial sectors within the U.S. economy as the main culprit in the slowdown of U.S. economic growth that took place after 1966. To provide an explanation for the slowdown we must go behind the measurements to identify the determinants of technical change at the sectoral level. For this purpose we require an econometric model of sectoral technical change. In this section we present a summary of the results of applying such an econometric model to detailed data on sectoral output and capital, labor, energy, and materials inputs for thirty-five individual industries in the United States.

Our complete econometric model is based on sectoral price functions for each of the thirty-five industries included in our study.[6] Each price function give the price of the output of the corresponding industrial sector as a function of the prices of capital, labor, energy, and materials inputs and time, where time represents the level of technology in the sector.[7] Obviously, an increase in the price of one of the inputs, holding the prices of the other inputs and the level of technology constant, will necessitate an increase in the price of output. Similarly, if the level of technology in a sector improves and the prices of all inputs into the sector remain the same, the price of output must fall. Price functions summarize these and other relationships among the prices of output, capital, labor, energy, and materials inputs, and the level of technology.

Although the sectoral price functions provide a complete model of production patterns for each sector, it is useful to express this model in an alternative and equivalent form. We can express the shares of each of the four inputs -- capital, labor, energy, and materials -- in the value of output as functions of the prices of these inputs and time, again representing the level of technology.[8] We can add to these four equations for the value shares an equation that expresses the rate of technical change as a function of the prices of the four inputs and time.[9] In fact, the negative of the rate of technical change is a function of the four input prices and time. This equation is our econometric model of sectoral technical change.[10]

Like any econometric model, the relationships determining the value shares of capital, labor, energy, and materials inputs and the negative of the rate of technical change involve unknown parameters that must be estimated from data for the individual industries. Included among these unknown parameters are biases of technical change that indicate the effect of changes in the level of technology on the value shares of each of the four inputs.[11] For example, the bias of technical change for capital input gives the change in the share of capital input in the value of output in response to changes in the level of technology, represented by time. Similarly, biases of technical change for labor, energy, and materials inputs give changes in the shares of labor, energy, and materials inputs in the value of output that results from changes in the level of technology.

We say that technical change is capital using if the bias of technical change for capital input is positive, that is, if changes in the level of technology result in an increase in the share of capital input in the value of output, holding all input prices constant. The quantity of capital input increases as technology changes, so that we say that the change in technology is capital using. Similarly, we say that technical change is capital saving if the bias of technical change for capital input is negative. As technology changes, the production process uses less capital input, so that the change in technology is capital saving.

Similarly, we can say that technical change is labor using or labor saving if the bias of technical change for labor input is positive or negative. As technology changes, the production process uses more or less labor input, depending on whether the change in technology is labor using or labor saving. We can associate energy using or energy saving technical change with positive or negative biases of technical change for energy input. Finally, we can associate materials using or materials saving technical change with positive or negative biases of technical change for materials input. Since the shares of all four inputs -- capital, labor, energy, and materials -- sum to unity, technical change that "uses" or "saves" all four inputs is impossible. In fact, the sum of the biases for all four must be precisely zero, since the changes in all four shares with any change in technology must sum to zero.

We have pointed out that our econometric model for each industrial sector of the U.S. economy includes an equation giving the negative of the sectoral rate of technical change as a function of the prices of the four inputs and time. The biases of technical change with respect to each of the four inputs appear as the coefficients of time, representing the level of technology, in the four equations for the value shares of all four inputs. The biases also appear as coefficients of the prices in the equation for the negative of the sectoral rate of technical change. This feature of our econometric model makes it possible to use information about changes in the value shares with time and changes in the rate of sectoral technical change with prices in determining estimates of the biases of technical change.

The biases of technical change express the dependence of value shares of the four inputs on the level of technology and also express the dependence of the negative of the rate of technical change on the input prices. We can say that capital using technical change, associated with a positive bias of technical change for capital input, implies that an increase in the price of capital input decreases the rate of technical change (or increases the negative of the rate of technical change). Similarly, capital saving technical change, associated with a negative bias for capital input, implies that an increase in the price of capital input increases the rate of technical change. Analogous relationships hold between biases of labor, energy, and materials inputs and the direction of the impact of changes in the prices of each of these inputs on the rate of technical change.[12]

Jorgenson and Fraumeni [1980] have fitted biases of technical change for thirty-five industrial sectors that make up the whole of the producing sector of the U.S. economy. They have also fitted the other parameters of the econometric model that we have described above. Since our primary concern in this section is to analyze the determinants of rates of technical change at the sectoral level, we focus on the patterns of technical change revealed in Table 3. We have listed the industries characterized by each of the possible combinations of biases of technical change, consisting of one or more positive biases and one or more negative biases.[13]

The pattern of technical change that occurs most frequently in Table 3 is capital using, labor using, energy using, and materials saving technical change. This pattern occurs for nineteen of the thirty-five industries analyzed by Jorgenson and Fraumeni. For this pattern of technical change the biases of technical change for capital input, labor input, and energy input are positive, and the bias of technical change for materials input is negative. This pattern implies that increases in the prices of capital input, labor input, and energy input decrease the rate of technical change, while increases in the price of materials input increase the rate of technical change.

Considering all patterns of technical change included in Table 3, we find that technical change is capital using for twenty-five of the thirty-five industries included in our study. Technical change is capital saving for the remaining ten industries. Similarly, technical change is labor using for thirty-one of the thirty-five industries and

Table 3

CLASSIFICATION OF INDUSTRIES BY BIASES OF TECHNICAL CHANGE

Pattern of Biases	Industries
Capital Using Labor Using Energy Using Material Saving	Agriculture, metal mining, crude petroleum and natural gas, nonmetallic mining, textiles, apparel, lumber, furniture, printing, leather, fabricated metals, electrical machinery, motor vehicles, instruments, miscellaneous manufacturing, transportation, trade, finance, insurance and real estate, services.
Capital Using Labor Using Energy Saving Material Saving	Coal mining, tobacco manufactures, communications, government enterprises.
Capital Using Labor Saving Energy Using Materials Saving	Petroleum refining.
Capital Using Labor Saving Energy Saving Material Using	Construction.
Capital Saving Labor Saving Energy Using Material Saving	Electric utilities.
Capital Saving Labor Using Energy Saving Material Saving	Primary metals.
Capital Saving Labor Using Energy Using Material Saving	Paper, chemicals, rubber, stone, clay and glass, machinery except electrical, transportation equipment and ordnance, gas utilities.
Capital Saving Labor Saving Energy Using Material Using	Food.

and labor saving for the remaining four industries; technical change is energy using for twenty-nine of the thirty-five industries included in Table 3 and is energy saving for the remaining six. Finally, technical change is materials using for only two of the thirty-five industries and is materials saving for the remaining thirty-three. We conclude that for a very large proportion of industries the rate of technical change decreases with increases in the prices of capital, labor, and energy inputs, and increases with the price of materials inputs.

4. Tax Policy

To identify the sources of variations in rates of technical change for industrial sectors of the U.S. economy we next consider the evolution of tax policy over the postwar period. Under current law taxpayers are permitted to deduct depreciation as an expense in arriving at income for tax purposes. Taxpayers are also allowed to reduce their tax liability by means of an investment tax credit based on purchases of equipment.[14] As tax rates at corporate and personal levels have increased, provisions for capital recovery under the tax code have become increasingly significant for economic policy. These provisions have an important impact in stimulating or retarding changes in the level of technology.

One approach to the efficient allocation of capital among assets is to permit taxpayers to deduct the decline in the value of their assets with age in arriving at taxable income. The decline in the value of an asset with age is called economic depreciation. Economic depreciation can be measured by observing the profile of prices corresponding to assets of different ages at a given point of time. A system of capital recovery enabling taxpayers to deduct economic depreciation would lead to an appropriate definition of income as a base for taxation and to an effective rax rate equal to the statutory rate for all assets.[15]

Conceptually, the most straightforward method for adjusting capital recovery for inflation would be to permit taxpayers to base capital consumption allowances on the cost of replacing assets rather than the cost

of acquiring them. The substitution of replacement cost accounting for historical cost accounting would provide an important additional element of discretion for the taxpayer. In addition to selecting depreciation formulas and lifetimes for assets, taxpayers would be allowed to select measures of replacement costs for assets.

Replacement cost accounting has recently been introduced for financial reporting purposes. Data on the replacement costs of assets have been developed and could be used for tax purposes with little additional effort or expense. The main advantage of replacement cost accounting for tax purposes is the possibility of linking capital consumption allowances to economic depreciation. However, the efficient allocation of capital would also require adjusting other tax provisions, including the investment tax credit, so as to produce the same effective tax rate for all assets.

An alternative method for adjusting capital recovery for inflation has been proposed by Auerbach and Jorgenson (1980). This proposal, described as the First Year Capital Recovery System, would permit taxpayers to deduct the present value of all future capital consumption allowances during the year an asset is acquired. Since the deduction is taken the same year an asset is acquired, capital consumption allowances are unaffected by inflation. The main advantage of the First Year System, like replacement cost accounting, is the potential link between capital consumption allowances and economic depreciation.

A different approach to the efficient allocation of capital among assets is to allow taxpayers to deduct the actual cost of acquisition of assets in arriving at taxable income. In this approach the acquisition of assets would be treated in precisely the same way as other business expenses. However, income from capital in the form of interest, dividends, or retained earnings would not be deducted from income for tax purposes. This would have the effects of shifting the base of taxation from income to consumption and reducing the effective income tax rate to zero.

Deducting economic depreciation and expensing the cost of acquisition of assets could be combined without sacrificing efficiency. For example, a certain proportion of net acquisition of assets could be expensed, while the remainder could be recovered through capital consumption allowances equal to economic depreciation. Combinations of these systems could lead to any effective tax rate between zero and the statutory tax rate. Although there are many ways to design a tax system that would lead to the same effective tax rate for all assets, the level of the effective tax rate could differ drastically among the alternative systems.

The system for capital recovery embodied in current tax law is the result of extended efforts to deal with the problem of inflation in the value of assets. In 1954 a system of capital consumption allowances was adopted that permitted taxpayers to use accelerated formulas for allocating capital recovery over the useful lifetime of an asset. Accelerated

depreciation was adopted in response to the rapid inflation in prices of assets during the Second World War and the Korean War.

Between 1954 and 1962 lifetimes used in calculating capital consumptions allowances were gradually reduced. In 1962 a new set of guideline lifetimes was adopted for tax purposes. These guideline lifetimes represented a further acceleration in capital recovery. In addition, an investment tax credit for purchases of equipment was adopted in 1962. The combination of the guideline lifetimes and the investment tax credit resulted in a dramatic stimulus to capital formation. Business fixed investment rose by forty percent over the four years from 1962 to 1966.

In the original legislation providing for the investment tax credit, the credit was linked to capital recovery by reducing the basis for calculating capital consumption allowances by the amount of the credit. This feature of the investment tax credit, the so-called Long Amendment, was repealed in 1964. As inflation rates began to rise in the late 1960's pressure began to build to adjust lifetimes for tax purposes to levels below the guidelines of 1962. In 1971 the Asset Depreciation Range System was adopted, permitting taxpayers to reduce lifetimes by as much as twenty percent. Finally, the investment tax credit was made permanent and the rate of the credit was increased in 1975.

We can summarize these developments by saying that the current system has developed through successive liberalization of depreciation formulas and lifetimes for tax purposes and through the introduction of the investment tax credit. These changes in the capital recovery provisions

of the tax code have been motivated by the need to bring capital consumption allowances into line with economic depreciation. However, double-digit inflation in the late 1970's has undercut the effectiveness of the earlier reforms.

To analyze the impact of inflation on capital recovery under the existing law, we have measured effective tax rates on equipment and structures for the corporate sector as a whole. The asset classes are described in detail in Table 4. For each asset we have given the tax lifetime embodied in current law, and the economic depreciation rate as calculated in a comprehensive study for the Department of the Treasury by Hulten and Wykoff (1981). We also give the proportion of nonresidential fixed investment in 1978 for each asset class.

To analyze the impact of changes in capital recovery provisions of the tax law over the postwar period, we have calculated the effective tax rate for equipment and structures in Table 5. Effective tax rates represent that fraction of each project's gross income which goes toward corporate taxes. Since such rates may vary from year to year, our figure represents the average tax rate faced by a new asset over its lifetime. To calculate an effective tax rate we first calculate the gross rate of return that a particular investment would have if the corporate tax rate were zero and there were no investment tax credit. We then calculate the net rate of return, taking account of corporate taxes and adjusting for depreciation deductions and the investment tax credit. We subtract the net rate of return from the gross rate of return and divide

Table 4

Asset Categories and Depreciation Rates

	Asset Category	Hulten-Wykoff[a] Depreciation Rate	BEA[a] Depreciation Rate	Percentage[b] of 1978 Corporate Investment
1	Furniture and Fixtures	11.00	12.67	2.7
2	Fabricated Metal Products	9.17	10.12	1.7
3	Engines and Turbines	7.86	8.88	0.7
4	Tractors	16.33	25.42	1.5
5	Agricultural Machinery	9.71	10.94	0.2
6	Construction Machinery	17.22	23.16	3.3
7	Mining and Oil Field Machinery	16.50	19.24	1.2
8	Metalworking Machinery	12.25	12.78	1.5
9	Special Industry Machinery	10.31	11.61	2.9
10	General Industrial Equipment	12.25	13.20	4.1
11	Office; Computing and Accounting Machinery	27.29	25.69	4.7
12	Service Industry Machinery	16.50	18.60	1.8
13	Electrical Machinery	11.79	12.51	10.4
14	Trucks, buses, and trailors	25.37	23.01	11.9
15	Autos	33.33	12.63	4.8
16	Aircraft	18.33	7.55	1.7
17	Ships and Boats	7.50	9.37	0.8
18	Railroad Equipment	6.60	16.97	1.7
19	Instruments	15.00	16.59	4.5
20	Other Equipment	15.00	16.95	1.5
21	Industrial Buildings	3.61	7.21	6.3
22	Commercial Buildings	2.47	5.18	7.3
23	Religious Buildings	1.88	3.55	0.0
24	Educational Buildings	1.88	3.52	0.0
25	Hospital Buildings	2.33	3.40	0.1
26	Other Nonfarm Buildings	4.54	6.00	0.4
27	Railroads	1.76	4.88	0.5
28	Telephone and Telegraph Facilities	3.33	6.35	2.8
29	Electric Light and Power	3.00	5.81	7.1
30	Gas	3.00	5.93	1.1
31	Other Public Utilities	4.50	7.75	0.3
32	Farm	2.37	5.88	0.1
33	Mining, Exploration, Shafts and Wells	5.63	11.74	6.1
34	Other Nonbuilding Facilities	2.90	6.38	0.5
35	Residential	1.30	2.71	1.7

a. Bureau of Economic Analysis (BEA) rates are estimated by Hulten and Wykoff (1981) to be those implicit in the National Income and Product Accounts. Both sets of rates are found in Table 2 of their study, except categories 27, 28, 29, 30, 31 and 35. These were derived for this study by applying Hulten-Wykoff methodology data disaggregated by type of asset.

b. Investment data for 34 nonresidential assets for farm, manufacturing, and nonfarm, nonmanufacturing sectors in current dollars from 1832 to 1978 were made available by John Musgrave of the Bureau of Economic Analysis. To derive corporate investment, percentages of corporate investment, also supplied by John Musgrave, are applied to the data. Corporate residential investment was provided by Jerry Silverstein of the Bureau of Economic Analysis.

Source: Jorgenson and Sullivan (1981).

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Table 5

Effective Corporate Tax Rates, 1946-1980

Year	Effective Corporate Tax Rate[a]			Statutory Tax Rate	Ratio (1)/(4)
	Total	Equipment	Structures		
1946	0.258	0.301	0.202	0.380	0.680
1947	0.265	0.301	0.201	0.380	0.697
1948	0.264	0.302	0.200	0.380	0.696
1949	0.266	0.307	0.200	0.380	0.699
1950	0.303	0.346	0.226	0.420	0.720
1951	0.389	0.436	0.310	0.510	0.762
1952	0.398	0.445	0.322	0.520	0.766
1953	0.418	0.460	0.348	0.520	0.803
1954	0.366	0.400	0.312	0.520	0.704
1955	0.370	0.405	0.311	0.520	0.712
1956	0.379	0.411	0.325	0.520	0.728
1957	0.394	0.429	0.335	0.520	0.758
1958	0.377	0.408	0.330	0.520	0.725
1959	0.412	0.444	0.355	0.520	0.792
1960	0.411	0.442	0.356	0.520	0.790
1961	0.397	0.428	0.346	0.520	0.764
1962	0.285	0.250	0.345	0.520	0.548
1963	0.263	0.219	0.339	0.520	0.506
1964	0.237	0.189	0.324	0.500	0.473
1965	0.214	0.160	0.310	0.480	0.445
1966	0.273	0.247	0.322	0.480	0.569
1967	0.267	0.240	0.318	0.480	0.556
1968	0.257	0.221	0.325	0.480	0.536
1969	0.371	0.378	0.357	0.480	0.773
1970	0.416	0.429	0.394	0.480	0.867
1971	0.289	0.244	0.367	0.480	0.602
1972	0.229	0.157	0.355	0.480	0.476
1973	0.256	0.188	0.379	0.480	0.533
1974	0.280	0.221	0.390	0.480	0.584
1975	0.211	0.131	0.357	0.480	0.439
1976	0.169	0.081	0.343	0.480	0.352
1977	0.135	0.041	0.331	0.480	0.281
1978	0.185	0.099	0.349	0.480	0.386
1979	0.198	0.121	0.343	0.460	0.430
1980	0.248	0.185	0.368	0.460	0.540

Source: Jorgenson and Sullivan (1981).

this difference by the gross rate to find the proportion of the gross return paid in taxes.

To assess the impact of the tax law prevailing in each year from 1946 to 1980 on capital recovery we present effective tax rates for equipment and structures for each year in Table 5. For purposes of comparison we also give the statutory rate on corporate income in each year. Under an ideal system for capital recovery the effective tax rates would be the same for all assets.[16] The first conclusion to be drawn from Table 5 is that effective tax rates have varied widely among assets and over time, depending on the provisions of the tax code and the rate of inflation.

Before 1954 effective tax rates for structures were well below the statutory tax rate on corporate income. Effective tax rates for equipment were above those for structures. While effective tax rates for both structures and equipment were reduced by the adoption of accelerated depreciation in 1954, effective tax rates for equipment remained above those for structures until the adoption of the guideline lifetimes and the investment tax credit in 1962. With the repeal of the Long Amendment in 1964 there was a further reduction in the effective tax rates on equipment.

As the pace of inflation quickened during the late 1960's the effective tax rates on equipment rose gradually; repeal of the investment tax credit in 1969 raised effective tax rates to levels above those for structures. Similarly, inflation and restriction of accelerated depreciation on structures to the 150 percent declining method after 1966

resulted in increases in the effective tax rates for structures by 1970 to the highest levels of the postwar period. For equipment reinstitution of the investment tax credit, adoption of the Asset Depreciation Range system, and the increase in the rate of the credit from seven to ten percent resulted in effective tax rates well below the statutory rate, even in the face of double digit inflation in 1973 and again in 1979.

Our overall conclusion is that effective tax rates on corporate income are inversely correlated with rates of technical change for the U.S. economy as a whole. Effective tax rates declined sharply between 1960 and 1965; the rate of technical change attained its postwar peak of 2.11 percent per year during this period. The weighted sum of sectoral rates of technical change was 2.17 percent from 1960 to 1966. Effective tax rates rose dramatically from 1965 to 1970; the rate of technical change declined to 0.05 percent per year during the period 1966-1969, a drop of 2.07 percent; the weighted sum of sectoral rates of technical change declined to 0.25 percent per year, a drop of 1.92 percent.

Effective tax rates declined from 1970 to 1972. The rate of technical change climbed from 0.04 percent per year for the period 1966-1969 to 0.95 percent per year for the period 1969-1973, an increase of 0.91 percent or slightly less than half of the drop from 1960-1966 to 1966-1969. The rise in the weighted sum of sectoral rates of technical change from 0.25 percent per year for the period 1966-1969 to 0.48 percent per year for the period 1969-1973 was less dramatic, but still substantial.

The most striking change in the relative prices of capital, labor, energy, and materials inputs that has taken place since 1973 is the staggering increase in the price of energy. The rise in energy prices began in 1972 before the Arab oil embargo, as the U.S. economy moved toward the double digit inflation that characterized 1973. In late 1973 and early 1974 the price of petroleum on world markets increased by a factor of four, precipitating a rise in domestic prices of petroleum products, natural gas, coal, and uranium. All industrial sectors of the U.S. economy experienced sharp increases in the price of energy relative to other inputs.

Slower growth in productivity at the sectoral level is associated with higher energy prices for twenty-nine of the thirty-five industries that make up the producing sector of the U.S. economy. The dramatic increases in energy prices contributed to the slowdown in productivity growth at the sectoral level. In the preceding section we have seen that the fall in sectoral productivity growth after 1973 is the primary explanation for the decline in productivity for the U.S. economy as a whole. Finally, we have shown that the slowdown in productivity growth during the period 1973-1976 is the main source of the fall in the rate of U.S. economic growth since 1973.

5. Recommendations

Our objective in this concluding section of the paper is to provide recommendations for changes in tax policy to stimulate future U.S. economic growth. For this purpose we cannot rely on the extrapolation of past trends in technical change. From 1960 to 1965 tax policy stimulated sectoral rates of technical change; from 1965 to 1969 tax policy retarded technical change; from 1969 to 1973 tax policy again acted as a stimulant. Comparing the period after 1973 with the rest of the post-war period, we can associate part of the decline in the rate of technical change with the dramatic increase in energy prices that followed the Arab oil embargo in late 1973 and early 1974.

During 1979 there has been a further sharp increase in world petroleum prices, following the interruption of Iranian petroleum exports that accompanied the revolution that took place in that country in late 1978. Although prices of petroleum sold by different petroleum exporting countries differ widely, the average price of petroleum imported into the United States has risen by 130 to 140 percent since December 1978. In January 1981 President Reagan announced that prices of petroleum products would be decontrolled immediately. As a consequence domestic petroleum prices in the United States have moved to world levels. Domestic natural gas prices will also be subject to gradual decontrol, moving to world levels as early as 1985 or, at the latest, 1987.

Given the sharp increase in the price of energy relative to the prices of other productive inputs, the prospects for productivity growth at the sectoral level are dismal. In the absence of any reduction in prices of capital and labor inputs during the 1980's, we can expect a decline in productivity growth for a wide range of U.S. industries, a decline in the growth of productivity for the U.S. economy as a whole, and a further slowdown in the rate of U.S. economic growth. To avoid a repetition of the unsatisfactory economic performances of the 1970's it is essential to undertake measures to reduce the prices of capital and labor inputs. The prices of these inputs can be reduced by cutting taxes on income from labor and capital.[18]

In considering economic policies to stimulate U.S. economic growth, the first step should be to design a new system for capital recovery that results in a substantial tax cut. Auerbach and Jorgenson have proposed that taxpayers should be allowed to deduct the present value of economic depreciation as an expense in arriving at income for tax purposes. The deduction would be allowed in the year an asset is acquired. Accordingly, they refer to the proposed system for capital recovery as the First Year Capital Recovery System.

Like the present system for capital recovery, the First Year Capital Recovery System is based on actual purchases of depreciable plant and equipment. However, to avoid the deterioration in the value of capital consumption allowances with inflation, the present value of economic depreciation is allowed as a deduction in the same year that the

asset is acquired. As a consequence, the capital consumption allowances are unaffected by inflation or by variations in the rate at which inflation takes place.

The second step in tax reform is to provide an investment tax credit that is proportional to the difference between the cost of acquisition of an asset and the First Year Allowance, as proposed by Brown (1980). By varying the proportion between zero and the statutory tax rate, it would be possible to produce any effective tax rate between the statutory rate and zero. Since the Brown Investment Tax Credit, like the Auerbach-Jorgenson First Year Allowance, would be taken in the same year an asset is acquired, it would create no claims on the government that are subject to capital gains and losses with changes in the rate of inflation. The combined Auerbach-Brown-Jorgenson First Year Capital Recovery System would preserve the existing features of U.S. tax law -- capital consumption allowances as a deduction from taxable income and the investment tax credit as an offset to tax liability.

As an illustration of a system for capital recovery under U.S. tax law based on the First Year Capital Recovery System, we present in Table 6 the First Year Allowances for all thirty-five types of assets listed in Table 1. These First Year Allowances are based on an after tax discount rate of six percent. We also present tax credits on these assets that would produce effective tax rates on all assets of zero, half the current statutory tax rate of forty-six percent, and the statutory tax rate itself. Investment tax credits would range from thirty-five percent

Table 6

First Year Capital Recovery System

Asset	First Year Allowance	Investment Tax Credit at Various Effective Tax Rates		
		Zero	.23	.46
1	0.645	0.16	0.08	0.00
2	0.602	0.18	0.09	0.00
3	0.565	0.20	0.10	0.00
4	0.729	0.12	0.06	0.00
5	0.616	0.18	0.09	0.00
6	0.740	0.12	0.06	0.00
7	0.731	0.12	0.06	0.00
8	0.669	0.15	0.06	0.00
9	0.630	0.17	0.09	0.00
10	0.669	0.15	0.08	0.00
11	0.818	0.08	0.04	0.00
12	0.731	0.12	0.06	0.00
13	0.660	0.16	0.08	0.00
14	0.807	0.09	0.04	0.00
15	0.946	0.07	0.04	0.00
16	0.752	0.11	0.06	0.00
17	0.553	0.21	0.10	0.00
18	0.521	0.22	0.11	0.00
19	0.712	0.13	0.07	0.00
20	0.712	0.13	0.07	0.00
21	0.373	0.29	0.14	0.00
22	0.290	0.33	0.16	0.00
23	0.237	0.35	0.18	0.00
24	0.237	0.35	0.18	0.00
25	0.278	0.33	0.17	0.00
26	0.428	0.26	0.13	0.00
27	0.225	0.36	0.18	0.00
28	0.355	0.30	0.15	0.00
29	0.331	0.31	0.15	0.00
30	0.331	0.31	0.15	0.00
31	0.426	0.26	0.13	0.00
32	0.281	0.33	0.17	0.00
33	0.482	0.24	0.12	0.00
34	0.324	0.31	0.16	0.00
35	0.173	0.38	0.19	0.00

on residential structures to seven percent on autos at an effective tax rate of zero for all assets. For an effective tax rate of twenty-three percent, which is comparable to present law at currently anticipated rates of inflation, investment tax credits would range from nineteen percent on residential structures to four percent on autos.

The First Year Capital Recovery System, as we have outlined it, would preserve the simplicity of the Auerbach-Jorgenson proposal. Existing provisions of the tax code on capital recovery could be replaced by a simple table like Table 6, giving the First Year Allowances and the Investment Tax Credits permitted by law. As under immediate expensing of assets, tax deductions and tax credits would depend only on current transactions in assets and would not require a cumbersome system of vintage accounts for auditing and verification. The main advantage of the First Year System over immediate expensing is the possibility of setting effective tax rates at levels other than zero.

Footnotes

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1. The methodology that underlies our decomposition of the growth of output is presented in detail by Jorgenson [1980].

2. The results presented in Table 1 are those of Fraumeni and Jorgenson [1980], who also provide annual data for output and inputs.

3. This conclusion contrasts sharply with that of Denison [1979]. For a comparison of our methodology with that of Denison, see Jorgenson and Griliches [1972].

4. The methodology that underlies our decomposition of productivity growth is presented in detail by Jorgenson [1980].

5. The results presented in Table 2 are those of Fraumeni and Jorgenson [1980], who also provide annual data for productivity growth.

6. Econometric models for each of the thirty-five industries are given by Jorgenson and Fraumeni [1981].

7. The price function was introduced by Samuelson [1953]. A complete characterization of the sectoral price functions employed in this study is provided by Jorgenson and Fraumeni [1981].

8. Our sectoral price functions are based on the translog price function introduced by Christensen, Jorgenson, and Lau [1971, 1973]. The translog price function was first applied at the sectoral level by Berndt and Jorgenson [1973] and Berndt and Wood [1975]. References to sectoral production studies incorporating energy and materials inputs are given by Berndt and Wood [1979].

9. Productivity growth is represented by the translog index introduced by Christensen and Jorgenson [1970]. The translog index of technical change was first derived from the translog price function by Diewert [1980] and by Jorgenson and Lau [1981].

10. This model of sectoral technical change is based on that of Jorgenson and Lau [1981].

11. The bias of technical change was introduced by Hicks [1932]. An alternative definition of the bias of technical change was introduced by Binswanger [1974a, 1974b]. The definition of the bias of technical change employed in our econometric model is due to Jorgenson and Lau [1981].

12. A complete characterization of biases of technical change is given by Jorgenson and Fraumeni [1981].

13. The results presented in Table 3 are those of Jorgenson and Fraumeni [1981]. Of the fourteen logically possible combinations of biases of technical change, only the eight patterns presented in Table 3 occur empirically.

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

15. The concept of economic depreciation is discussed in greater detail by Jorgenson [1973].

16. The criterion that effective tax rates should be the same for all assets is discussed in more detail by Auerbach [1980].

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

18. An analysis of alternative proposals for cutting taxes on income from capital is presented by Auerbach and Jorgenson [1980].

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INFLATION AND CORPORATE CAPITAL RECOVERY

by

Dale W. Jorgenson and Martin A. Sullivan

1. Introduction

The objective of this paper is to analyze the impact of inflation on capital recovery under the U.S. corporate income tax. Corporate tax payments depend on the statutory corporate tax rate. They also depend on capital consumption allowances, expensing of investments, investment tax credits, and the deductibility of interest. We refer to the tax rate actually paid as the effective tax rate. The common feature of tax systems leading to an efficient allocation of capital is that they result in the same effective tax rate for all assets.

One approach to the efficient allocation of capital among assets is to permit taxpayers to deduct the decline in the value of their assets with age in arriving at taxable income. The decline in the value of an asset with age is called economic depreciation. Economic depreciation can be measured by observing the profile of prices corresponding to assets of different ages at a given point of time. A system of capital recovery enabling taxpayers to deduct economic depreciation would lead to income as a base for taxation and to an effective tax rate equal to the statutory rate for all assets.

An alternative approach to the efficient allocation of capital among assets is to allow taxpayers to deduct the actual cost of acquisition of assets in arriving at taxable income. In this approach the acquisition of assets would be treated in precisely the same way as other

business expenses. However, income from capital in the form of interest, dividends, or retained earnings would not be deducted from income for tax purposes. This would have the effects of shifting the base for taxation from income to consumption and reducing the effective income tax rate to zero.

Deducting economic depreciation and expensing the cost of acquisition of assets could be combined without sacrificing efficiency. For example, a certain proportion of the net acquisition cost of assets could be expensed, while the remainder could be recovered through capital consumption allowances equal to economic depreciation. Combinations of these systems could lead to any effective tax rate between zero and the statutory tax rate. Although there are many ways to design a tax system that would lead to the same effective tax rate for all assets, the level of the effective tax rate can differ widely among the alternative systems.

To analyze the impact of inflation on the U.S. corporate income tax we first determine the effective tax rate for each type of asset for each year of the postwar period 1946-1980. Throughout this period the system of capital recovery has been based on the historical cost of an asset. Cost of acquisition provides the basis for the investment tax credit as an offset to tax liability. Historical cost also provides the basis for capital consumption allowances as a deduction from income for tax purposes. Finally, interest payments are also treated as a deduction from income under U.S. law.

Our most surprising finding is that for currently anticipated rates of inflation, which are among the highest of the postwar period, U.S. tax law results in effective corporate tax rates that are well below the statutory rate. This is due to the liberalization of capital consumption allowances during the postwar period and, most importantly, to the introduction of the investment tax credit. We also find that an increase in the rate of inflation for any given set of tax provisions results in higher effective tax rates on all corporate assets, while a decrease results in lower effective tax rates.

Our second major finding is that differences in effective tax rates among assets under the U.S. corporate income tax are very substantial. Transfers of investment from lightly taxed assets to heavily taxed assets would result in large gains in future output with no sacrifice of consumption either now or in the future. Under current law the differences in effective tax rates among assets would increase with a decrease in the rate of inflation, thereby further reducing the efficiency of capital allocation.

We next consider the likely impact of two specific proposals for more rapid capital recovery:

1. The Reagan Administration proposal, introduced by Congressmen Conable and Jones in 1979 and advanced in somewhat different form by President Reagan in 1981.

2. The Senate Finance Committee proposal, originally introduced by Senator Bentsen in 1980 and reintroduced by Senator Long in 1981.

The Reagan Administration and Senate Finance Committee proposals involve accelerated capital recovery rather than economic depreciation or expensing of acquisition costs. More rapid recovery of the cost of acquiring assets would be permitted by substituting more generous formulas and shorter lifetimes for those employed under current law. In addition, the rate of the investment tax credit would be increased. The objective of these proposals is to reduce effective tax rates on all assets.

In addition to the two proposals listed above for revising tax provisions for capital recovery, we consider expensing the costs of acquisition of assets and deducting economic depreciation as potential approaches to capital recovery under the U.S. corporate income tax. For current law and for each of the two proposed changes, we determine the effective tax rate for each type of asset. Under economic depreciation the effective rate for all assets would be equal to the statutory tax rate, while under expensing the effective tax rate on all assets would be equal to zero.

We find that the U.S. corporate income tax provides capital consumption allowances for corporate investment as a whole that are in line with economic depreciation at currently anticipated rates of inflation. At these inflation rates the Reagan Administration proposal would provide capital consumption allowances 33.6 percent in excess of economic depreciation. The Senate Finance Committee proposal would result in an excess of 27.5 percent.

At current rates of inflation the effective tax rate on new corporate investment under present law is twenty-four percent or a little over half the statutory rate of forty-six percent, due mainly to the impact of the investment tax credit. The Senate Finance Committee proposals would reduce the effective tax rate on corporate investment to thirteen percent or a little over one fourth the statutory rate. Finally, the Reagan Administration proposal would result in a negative effective tax rate for corporate investment.

Under the Reagan Administration proposal the combination of very short asset lifetimes for tax purposes and an increase in the investment tax credit for some assets would imply that the corporate income tax would be replaced by a corporate income subsidy for depreciable assets. Tax deductions and credits for these assets would be available to "shelter" income from nondepreciable assets such as land, inventories, and financial claims. The negative effective tax rate under the Reagan proposal would rise to forty-six percent at rates of inflation anticipated in 1966 and to fifty-eight percent at rates of inflation anticipated in 1960.

The second issue we consider in analyzing the impact of inflation on capital recovery under present law and alternative proposals is differences in effective tax rates among assets. Under present U.S. tax law the difference between effective tax rates on equipment and structures is sixteen percent at currently anticipated rates of inflation. Under the Reagan Administration proposal this difference would widen to thirty-six percent. The gap for the Senate Finance Committee proposal would be twenty-three percent.

We conclude that differences in effective tax rates among assets under present U.S. tax law are substantial, even at the very high anticipated rates of inflation prevailing currently. These differences would increase with a decrease in the rate of inflation, reducing efficiency in the allocation of capital. The differences in effective rates would widen significantly under the Senate Finance Committee proposal and would widen even further under the Reagan Administration proposal. Just as under present law, these gaps would increase with a decrease in the rate of inflation.

In closing we outline an approach to the reform of capital recovery under the U.S. corporate income tax that would deal effectively with the problem of inflation. The first step would be to replace existing capital recovery allowances for tax purposes by a first year allowance, as proposed by Auerbach and Jorgenson (1980). The first year allowance would provide taxpayers with a deduction from income equal to the present value of economic depreciation on an asset over its lifetime.

The second step in reform of capital recovery would be to provide an investment tax credit proportional to the difference between the cost of acquisition of an asset and the first year allowance, as proposed by Brown (1981). By varying the proportion of the investment tax credit between zero and the statutory corporate tax rate, it would be possible to produce any effective tax rate between the statutory rate and zero. Since the first year allowance and the investment tax credit would be taken in the same year an asset is acquired, the resulting First Year Capital Recovery System would make corporate capital recovery completely independent of the rate of inflation.

2. Theoretical Framework

To analyze the impact of inflation on capital recovery under U.S. tax law we begin by modeling the provisions of the law over the post-war period 1946-1980 and under changes in tax law proposed by the Reagan Administration and the Senate Finance Committee. For simplicity we limit ourselves to the provisions of the corporate income tax. We introduce the characteristic features of the tax law into the annualized cost or rental value of each type of asset. For this purpose we employ the concept of rental value introduced by Jorgenson (1963, 1965) and further developed by Hall and Jorgenson (1967).[1]

Under U.S. tax law the rental price of capital services depends on the statutory tax rate, which we denote by u, the depreciation formula giving capital consumption allowances at time s on one dollar's worth of investment at time t, denoted by D(s-t), and the rate of the investment tax credit, denoted k.[2] We can determine the values of these tax parameters for each type of assets for each year during the period 1946-1980 and for each of the proposed changes in tax law. Using the rental price of capital services, we can determine the effective tax rate corresponding to each set of tax parameters.

The rental price of capital services is defined, implicitly, by the equality between the cost of acquisition of an asset at time t, say q(t), and the present value of future rentals after taxes. In the absence of taxation this equality can be written:

$$q(t) = \int_t^\infty e^{-(r + \pi)(s-t)} e^{-\delta(s-t)} c(s) \, ds \, .$$

In this formula the rental price of capital services at time s, $c(s)$, is multiplied by the quantity of capital services at time s, $e^{-\delta(s-t)}$.

We assume that the quantity of capital services resulting from the acquisition of one unit of the capital asset at time t declines exponentially at the rate of economic depreciation δ. Hulten and Wykoff (1981) have shown that exponential or geometric decline in the quantity of capital services provides a satisfactory approximation to actual patterns of decline.[3] The rental value at time s, $e^{-\delta(s-t)}c(s)$, is discounted by the factor $e^{-(r + \pi)(s-t)}$, where $\pi = \frac{\dot{q}}{q}$ is the rate of inflation in the price of assets and r is the rate of return corrected for inflation.

Differentiating both sides of the identity between the cost of acquisition of an asset and the present value of future rentals, we obtain:

$$c = q\,(r + \delta)\ .$$

The rental price is the product of the acquisition price and the sum of the rate of return corrected for inflation and the rate of depreciation. We can solve this expression for the rate of return, obtaining:

$$r = \frac{c}{q} - \delta\ .$$

For productive efficiency in the allocation of capital, the addition to wealth generated by one dollar's worth of an asset must be the same for all assets. This addition to wealth is measured by the rate of return before correction for inflation, $r + \pi$.

In the presence of taxation the cost of acquisition of an asset is reduced by an offset to tax liability for the investment tax credit and by deductions from taxable income for capital consumption allowances. The acquisition cost after taxes is equal to the present value of future rentals after taxes. The investment tax credit, $kq(t)$, is a direct offset to tax liability and is not discounted. We can view capital consumption allowances as an offset to the cost of acquisition of an asset by introducing the present value of capital consumption allowances, say z:

$$z = \int_t^\infty e^{-[r(1-u) + \pi](s-t)} D(t-s)\, ds$$

where $r(1-u) + \pi$ is the after tax discount rate.

Given the definition of the present value of capital consumption allowances, we can express the cost of acquisition of an asset at time t, net of the investment tax credit and the present value of tax deductions for capital consumption, as the present value of future rentals after taxes:

$$(1-k-uz)\, q(t) = \int_t^\infty e^{-[r(1-u) + \pi](s-t)} e^{-\delta(s-t)} (1-u)\, c(s)\, ds .$$

Our final step in modeling the provisions for capital recovery under U.S. tax law is to determine the rental price of capital services as a function of the cost of acquisition of an asset q(t), the rate of return r, and the tax parameters -- k, u, and z. For this purpose we differentiate both sides of the equality between the cost of acquisition of an asset after taxes and the present value of future rentals after taxes, obtaining:

$$c = \frac{1 - k - uz}{1-u} q \quad [r(1-u) + \delta] .$$

Efficiency in the allocation of capital requires that the addition to wealth generated by the acquisition of one dollar's worth of an asset, net of depreciation, is the same for all assets. This addition to wealth is measured by the social rate of return before correction for inflation, say $\rho + \pi$, where:

$$\rho = \frac{c}{q} - \delta .$$

Maximization of private wealth requires that the addition to wealth generated by the acquisition of one dollar's worth of an asset, net of both depreciation and taxes, is the same for all assets. This addition to wealth is measured by the private rate of return before correction for inflation $r(1-u) + \pi$.

To summarize the impact of U.S. tax law on capital recovery on the efficiency of capital allocation, we employ the effective tax rate, say e. Reducing the social rate of return by the effective tax rate results in the private rate of return after taxes:

$$(1-e)\,\rho = (1-u)\,r \; .$$

We can express the effective tax rate as a function of the private rate of return, the statutory tax rate, the investment tax credit, and the present value of capital consumption allowances:

$$e = 1 - \frac{(1-u)\,r}{\frac{1-k-uz}{1-u}\,[(1-u)\,r + \delta] - \delta} \; .$$

Maximization of private wealth results in an efficient allocation of capital only if the effective tax rate is the same for all assets.[4]

If capital consumption allowances were equal to economic depreciation, the present value of these allowances would be given by:

$$z = \int_t^\infty e^{-r(1-u)(t-s)}\,\delta\,e^{-\delta(t-s)}\,ds$$

$$= \frac{\delta}{r(1-u)+\delta} \; .$$

If the investment tax credit were equal to zero, the effective tax rate for all assets would be equal to the statutory tax rate. Alternatively, if the acquisition of assets could be immediately expensed, the present

value of capital consumption allowances would be equal to unity. Again, setting the investment tax credit equal to zero, the effective tax rate for all assets would be equal to zero. Expensing a proportion of the cost of acquisition of assets and recovering the remainder through economic depreciation could lead to any effective tax rate between zero and the statutory rate.[5]

3. Empirical Implementation

The measurement of effective tax rates under U.S. tax law requires data on economic depreciation, the after tax rate of return, capital consumption allowances for tax purposes, and the investment tax credit. Hulten and Wykoff (1981) have estimated rates of economic depreciation for all types of assets employed in the U.S. national income and product accounts. These rates of economic depreciation are based an analysis of data on the prices of assets of different ages. Economic depreciation is measured by the decline in the value of an asset with age.

In Table 1 we present a list of the assets employed in the U.S. national accounts, the corresponding economic depreciation rates estimated by Hulten and Wykoff, and the percentage of each asset in total corporate investment in 1978. The first twenty categories of assets are classified as producers' durable equipment, the next fourteen are classified as nonresidential structures, and the last is residential structures. Economic depreciation rates for equipment range from 33.33 percent per year for automobiles to 6.60 percent per year for railroad equipment. Rates for structures range from 5.63 percent per year for mining, exploration, shafts, and wells to 1.30 percent per year for residential structures.

Hulten and Wykoff (1981) have compared their estimates of rates of economic depreciation by type of asset with estimates employed since 1976 in the U.S. national income and product accounts.[6] We present average economic depreciation rates employed in the national accounts in Table 1. The depreciation rates for producers' durable equipment obtained by

Table 1

Asset Categories and Depreciation Rates

	Asset Category	Hulten-Wykoff[a] Depreciation Rate	BEA[a] Depreciation Rate	Percentage[b] of 1978 Corporate Investment
1	Furniture and Fixtures	11.00	12.67	2.7
2	Fabricated Metal Products	9.17	10.12	1.7
3	Engines and Turbines	7.86	8.88	0.7
4	Tractors	16.33	25.42	1.5
5	Agricultural Machinery	9.71	10.94	0.2
6	Construction Machinery	17.22	23.16	3.3
7	Mining and Oil Field Machinery	16.50	19.24	1.2
8	Metalworking Machinery	12.25	12.78	3.5
9	Special Industry Machinery	10.31	11.61	2.9
10	General Industrial Equipment	12.25	13.20	4.1
11	Office; Computing and Accounting Machinery	27.29	25.69	4.7
12	Service Industry Machinery	16.50	18.60	1.8
13	Electrical Machinery	11.79	12.51	10.4
14	Trucks, buses, and trailors	25.37	23.01	11.9
15	Autos	33.33	17.63	4.8
16	Aircraft	18.33	7.55	1.7
17	Ships and Boats	7.50	9.37	0.8
18	Railroad Equipment	6.60	16.97	1.7
19	Instruments	15.00	16.59	4.5
20	Other Equipment	15.00	16.95	1.5
21	Industrial Buildings	3.61	7.21	6.3
22	Commercial Buildings	2.47	5.18	7.3
23	Religious Buildings	1.89	3.55	0.0
24	Educational Buildings	1.88	3.52	0.0
25	Hospital Buildings	2.33	3.40	0.1
26	Other Nonfarm Buildings	4.54	6.00	0.4
27	Railroads	1.76	4.88	0.5
28	Telephone and Telegraph Facilities	3.33	6.35	2.8
29	Electric Light and Power	3.00	5.81	7.1
30	Gas	3.00	5.93	1.1
31	Other Public Utilities	4.50	7.75	0.3
32	Farm	2.37	5.88	0.1
33	Mining, Exploration, Shafts and Wells	5.63	11.74	6.1
34	Other Nonbuilding Facilities	2.90	6.38	0.5
35	Residential	1.30	2.71	1.7

a. Bureau of Economic Analysis (BEA) rates are estimated by Hulten and Wykoff (1981) to be those implicit in the National Income and Product Accounts. Both sets of rates are found in Table 2 of their study, except categories 27, 28, 29, 30, 31 and 35. These were derived for this study by applying Hulten-Wykoff methodology to data disaggregated by type of asset.

b. Investment data for 34 nonresidential assets for farm, manufacturing, and nonfarm, nonmanufacturing sectors in current dollars from 1832 to 1978 were made available by John Musgrave of the Bureau of Economic Analysis. To derive corporate investment, proportions of investment in each category of assets by corporations, also supplied by John Musgrave, were employed. Corporate residential investment was provided by Jerry Silverstein of the Bureau of Economic Analysis.

Hulten and Wykoff are similar in the aggregate to those employed in the U.S. national accounts, but differ for specific types of equipment. The economic depreciation rates for nonresidential structures estimated by Hulten and Wykoff are much lower than these employed in the U.S. national accounts. Estimates employed in the national accounts are based on studies of useful lives for tax purposes summarized in Bulletin F (1942), issued by the Internal Revenue Service, and on data on retirement of assets collected by Marston, Winfrey, and Hempstead (1953).

The first step in the estimation of effective tax rates under U.S. tax law is to measure the offset to the cost of acquisition of assets provided by capital consumption allowances. To measure this offset we require present values of these allowances over the lifetime of each asset. Capital consumption allowances for tax purposes depend on accounting formulas for allocating historical cost of an asset over its lifetime. They also depend on useful lifetimes and salvage values for assets permitted for tax purposes. Although lifetimes, salvage values, and accounting formulas are provided by statute or by regulations, considerable discretion is permitted to individual taxpayers in the calculation of capital consumption allowances.

To summarize practices permitted by the Internal Revenue Service in calculating capital consumption allowances for tax purposes, we have developed a detailed simulation model for the generation of the capital consumption allowances actually claimed by corporations. This model incorporates information about lifetimes and salvage values of assets and accounting formulas permitted for tax purposes. In Table 2 we pre-

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Table 2

Asset Lifetimes for Tax Purposes

	Asset Category	Bulletin F[a] Lifetime	Guideline[b] ADR Midpoint Lifetime
1	Furniture and Fixtures	17.6	10.0
2	Fabricated Metal Products	21.2	12.5
3	Engines and Turbines	24.7	15.6
4	Tractors	9.4	4.3
5	Agricultural Machinery	20.0	10.0
6	Construction Machinery	10.6	9.9
7	Mining and Oilfield Machinery	11.8	9.6
8	Metalworking Machinery	18.8	12.7
9	Special Industry Machinery	18.8	12.7
10	General Industrial Equipment	16.5	12.3
11	Office, Computing, and Accounting Machinery	9.4	10.0
12	Service Industry Machinery	11.8	10.3
13	Electrical Machinery	16.5	12.4
14	Trucks, Buses, and Truck Trailers	10.6	5.6
15	Autos	11.8	3.0
16	Aircraft	10.6	6.3
17	Ships and Boats	25.9	18.0
18	Railroad Equipment	29.4	15.0
19	Instruments	12.9	10.6
20	Other Equipment	12.9	10.2
21	Industrial Buildings	31.8	26.8
22	Commercial Buildings	42.3	47.6
23	Religious Buildings	56.5	48.0
24	Educational Buildings	56.5	48.0
25	Hospital Buildings	56.5	48.0
26	Other Non-Farm Buildings	36.5	30.9
27	Railroads	60.0	30.0
28	Telephone and Telegraph Facilities	31.8	27.0
29	Electric Light and Power	35.3	27.0
30	Gas	35.3	24.0
31	Other Public Utilities	30.6	22.0
32	Farm	44.7	25.0
33	Mining, Exploration, Shafts, and Wells	18.8	6.8
34	Other Nonbuilding Facilities	36.5	28.2
35	Residential	40.0	40.0

a. Bulletin F lifetimes are obtained from the capital stock study by the Bureau of Economic Analysis (1976).

b. Guideline ADR midpoint lifetimes were calculated in three stages: 1. Where possible, Guideline lives were applied directly to asset categories. 2. Using industry investment in each category, industry-specific lifetimes were weighted to obtain average asset lifetimes. 3. Investment not covered otherwise was assigned 65 percent of Bulletin F lifetimes, which the Treasury estimated to be equivalent to Guideline lifetimes on average.

sent two sets of lifetimes by type of asset -- Bulletin F lifetimes, introduced by the Internal Revenue Service in 1942, and Guideline lifetimes from the Asset Depreciation Range System introduced in 1971.

Considerable survey evidence is available about the accounting formulas actually employed by taxpayers in calculating corporate capital consumption allowances. We can combine this information with scattered evidence on lifetimes used for tax purposes and on the salvage values of assets. Finally, we can simulate the values of capital consumption allowances claimed for tax purposes on the basis of data on investment by type of asset. We have adjusted our estimates of accounting formulas, lifetimes, and salvage values employed for tax purposes to fit historical data on capital consumption allowances; additional details are given in the Appendix to this paper. We present simulated capital consumption allowances and estimates of these allowances based on Statistics of Income in Table 3.[7] We also present simulated and actual values of the proportion of capital consumption allowance calculated on the basis of straight-line accounting formulas.

The results of our simulation of capital consumption allowances actually claimed by U.S. corporations over the period 1946 to 1978 are presented in Table 4. Since these data include capital consumption allowances on assets acquired in earlier years, we have developed estimates of lifetimes and salvage values for assets and relative proportions of newly acquired assets depreciated by straight-line and accelerated methods back to 1930. We have assumed that depreciation practices before 1930 are the same as those that prevailed in that year.

Table 3

Simulated Corporate Capital Consumption Allowances, 1946-1978

	Corporate Capital Consumption Allowances			Proportion of Depreciation Using Straight-line	
Year	Simulated	Actual[a]	Difference (1)/(2)	Simulated	Actual[b]
1946	4.82	4.59	0.23	0.97	
1947	5.53	5.68	-0.14	0.95	
1948	6.49	6.82	-0.33	0.94	
1949	7.43	7.77	-0.34	0.94	
1950	8.37	8.50	-0.13	0.93	
1951	9.67	9.81	-0.14	0.93	
1952	11.24	11.10	0.14	0.93	
1953	12.92	12.79	0.13	0.92	
1954	14.64	14.50	0.34	0.89	0.89
1955	17.03	17.21	-0.19	0.82	0.81
1956	19.10	18.90	0.20	0.74	0.74
1957	20.97	20.90	0.07	0.68	0.70
1958	22.35	22.23	0.12	0.63	0.61
1959	23.64	23.62	0.02	0.59	0.58
1960	25.05	25.25	-0.20	0.54	0.53
1961	26.38	26.61	-0.23	0.50	0.50
1962	30.50	30.44	0.06	0.48	
1963	32.48	32.44	0.04	0.45	
1964	34.72	34.57	0.15	0.42	
1965	37.83	37.41	0.42	0.39	
1966	41.25	40.61	0.64	0.36	
1967	44.54	44.12	0.42	0.34	
1968	49.53	48.09	0.44	0.32	
1969	52.99	52.99	0.00	0.30	
1970	56.64	56.61	0.02	0.28	
1971	60.33	60.89	-0.55	0.27	
1972	66.15	67.88	-1.73	0.25	
1973	74.08	73.75	0.34	0.24	
1974	92.31	81.01	0.70	0.22	
1975	89.66	89.22	0.43	0.21	
1976	97.20	97.12	0.08	0.20	
1977	107.73	109.29	-1.56	0.19	
1978	122.26	119.81	2.46	0.17	

a. Corporate capital consumption allowances based on Statistics of Income for corporations were prepared by Jerry Silverstein of the Bureau of Economic Analysis for this study.

b. Proportions of corporate capital consumption allowances using the straight-line method are reported for the years 1954-1961 in the Statistics of Income: Corporation Income Tax Returns, 1959-1960, p. 7, Table E, and 1961-1962, p. 6, Table E.

Table 4

Tax Parameters Employed in Simulation of Corporate Capital Consumption Allowances

Year	Average Equipment Lifetime	Average Structures Lifetime	Proportion Of New Investment Using Accelerated Methods	Equipment Salvage Value as Proportion of Original Cost
1930	11.80	25.67	0.00	0.08
1931	11.02	25.34	0.00	0.08
1932	11.07	24.14	0.00	0.08
1933	10.88	22.93	0.00	0.08
1934	15.72	33.18	0.00	0.10
1935	15.30	31.71	0.00	0.10
1936	15.71	32.27	0.00	0.10
1937	15.98	30.77	0.00	0.10
1938	15.00	30.13	0.00	0.10
1939	13.77	28.62	0.00	0.10
1940	14.32	28.67	0.00	0.10
1941	14.42	28.53	0.00	0.10
1942	15.65	28.68	0.00	0.10
1943	15.36	28.04	0.08	0.09
1944	14.81	27.34	0.08	0.09
1945	13.63	27.23	0.08	0.09
1946	13.16	28.14	0.08	0.09
1947	13.80	27.93	0.08	0.09
1948	13.64	28.12	0.08	0.09
1949	13.56	28.21	0.08	0.09
1950	13.11	27.80	0.08	0.09
1951	13.69	27.50	0.08	0.09
1952	13.72	27.09	0.09	0.09
1953	13.56	27.25	0.09	0.09
1954	13.32	27.18	0.30	0.06
1955	13.00	27.06	0.52	0.06
1956	13.33	27.59	0.52	0.06
1957	13.36	27.29	0.57	0.05
1958	12.99	27.47	0.65	0.06
1959	12.60	27.45	0.69	0.06
1960	12.65	27.38	0.70	0.06
1961	12.32	27.24	0.71	0.06
1962	11.73	27.27	0.71	0.05
1963	11.54	27.55	0.72	0.04
1964	11.44	27.48	0.72	0.03
1965	11.23	27.80	0.73	0.03
1966	11.09	27.59	0.73	0.03
1967	11.02	27.57	0.74	0.03
1968	10.43	27.39	0.75	0.03
1969	10.33	27.85	0.77	0.03
1970	10.39	27.55	0.78	0.03
1971	9.66	28.09	0.80	0.01
1972	8.51	28.06	0.81	0.01
1973	8.40	27.83	0.82	0.01
1974	8.57	27.06	0.83	0.01
1975	8.71	25.23	0.84	0.01
1976	8.43	24.75	0.84	0.01
1977	7.78	24.58	0.85	0.01
1978	7.64	24.72	0.85	0.01

Our results include estimates of lifetimes used for tax purposes for all thirty-five types of assets listed in Table 1. The results also include simulated percentages of capital consumption allowances calculated on the basis of accelerated methods. Finally, we present simulated salvage values as a proportion of the acquisition cost of equipment. Salvage values for structures are simulated at one percent of acquisition cost throughout the period.

Comparing the average lifetimes presented in Table 4 with the statutory lifetimes presented in Table 2, we observe that lifetimes used for structures have declined steadily over the postwar period. At the end of this period the lifetimes are closely comparable to those employed during the 1930's. By contrast the lifetimes used for equipment have declined dramatically over the postwar period after rising during the 1930's. Although accelerated methods for calculating capital consumption allowances were used before 1954, the proportion of assets treated by these methods jumped from nine percent in 1953 to thirty percent in 1954 and fifty-two percent in 1955. Since that time the proportion of assets depreciated by accelerated methods has risen steadily to a level of eighty-five percent in 1978. Salvage values as a proportion of cost of acquisition of equipment rose from eight percent in 1933 to ten percent in 1934. Since that time this ratio has declined steadily, reaching the level of one percent in 1978.

Our simulation model of capital consumption provides estimates of lifetimes and salvage values of assets and accounting formulas employed by taxpayers for each year and for each of the thirty-five types of

assets listed in Table 1. To proceed with the calculation of present values of capital consumption allowances for new assets acquired in each year, we require appropriate discount factors to be applied to the capital consumption allowances permitted under U.S. law. The discount factors depend on after tax rates of return, not adjusted for inflation, since capital consumption allowances were based on historical cost. If capital consumption allowances were based on replacement cost, the inflation in capital consumption allowances would precisely offset the inflation in the after tax rate of return.

Since tax deductions for capital consumption are an obligation of the U.S. government, we have constructed discount factors for these allowances on the basis of yields on U.S. government securities. These yields have precisely the characteristics appropriate to the discounting of government obligations. Second, since tax deductions are calculated at historical cost of acquisition of assets, the discount factors should not be corrected for inflation. Yields on government obligations embody anticipations about inflation that are current at the time an investment is made. We present yields on government securities by maturity in Table 5.

We have estimated present values of capital consumption allowances for tax purposes for each of the thirty-five types of assets presented in Table 1. We have weighted these present values by actual investment by type of asset in Table 6. The first column of this Table gives the present value for capital consumption allowances for tax purposes under

Table 5

Yields on U.S. Government Securities by Maturity, 1950-1980[a]

Year	1 yr.	2 yr.	3 yr.	4 yr.	5 yr.	7 yr.	10 yr.	20 yr.	30 yr.
1950	1.28	1.37	1.42	1.47	1.54	1.77	2.11	2.39	2.39
1951	1.70	1.83	1.90	1.96	2.03	2.18	2.41	2.60	2.60
1952	1.87	2.03	2.14	2.22	2.26	2.30	2.47	2.68	2.68
1953	2.13	2.32	2.42	2.50	2.57	2.61	2.78	2.92	3.25
1954	1.03	1.24	1.46	1.70	1.89	2.11	2.43	2.57	2.76
1955	1.97	2.27	2.42	2.51	2.58	2.64	2.72	2.83	2.95
1956	2.69	3.03	3.10	3.12	3.13	3.10	3.08	3.07	3.10
1957	3.48	3.58	3.63	3.64	3.63	3.59	3.54	3.45	3.44
1958	2.17	2.50	2.75	2.89	2.98	3.10	3.27	3.45	3.48
1959	3.90	4.10	4.21	4.26	4.26	4.23	4.13	4.12	4.08
1960	3.55	3.78	3.97	4.08	4.13	4.13	4.13	4.13	4.12
1961	2.89	3.23	3.46	3.61	3.69	3.75	3.84	3.90	3.94
1962	3.05	3.28	3.47	3.61	3.71	3.91	3.96	4.02	4.06
1963	3.29	3.45	3.61	3.72	3.80	3.83	3.98	4.06	4.07
1964	3.80	3.94	4.01	4.05	4.08	4.12	4.17	4.16	4.19
1965	4.07	4.11	4.15	4.17	4.20	4.22	4.25	4.23	4.22
1966	5.12	5.19	5.20	5.18	5.14	5.03	4.86	4.72	4.69
1967	4.77	4.87	4.94	4.98	5.00	5.00	4.97	4.93	4.90
1968	5.54	5.56	5.57	5.57	5.56	5.58	5.48	5.40	5.35
1969	6.95	6.90	6.85	6.78	6.73	6.63	6.46	6.25	6.17
1970	7.05	7.22	7.33	7.41	7.43	7.30	7.21	6.79	6.73
1971	4.89	5.22	5.56	5.78	5.96	6.14	6.11	6.01	6.00
1972	4.89	5.29	5.59	5.77	5.90	6.07	6.23	5.82	5.80
1973	7.24	6.85	6.78	6.78	6.76	6.74	6.73	6.97	6.99
1974	8.23	7.83	7.75	7.74	7.73	7.66	7.31	7.93	7.98
1975	6.65	7.18	7.36	7.47	7.61	7.72	7.42	8.04	8.21
1976	5.92	6.50	6.82	7.04	7.20	7.46	7.53	7.86	7.94
1977	5.94	6.30	6.55	6.77	6.91	7.11	7.36	7.62	7.68
1978	8.20	8.22	8.21	8.22	8.23	8.28	8.33	8.42	8.42
1979	10.54	9.99	9.57	9.47	9.40	9.37	9.34	9.24	9.20
1980	11.61	11.38	11.10	11.12	11.15	11.12	11.16	11.09	11.03

a. Source: Salomon Brothers, Analytical Handbook of Yields and Yield Ratios. These yields are used to construct discount factors for calculating the present value of depreciation allowances.

Table 6

Present Values of Corporate Capital Consumption Allowances for Tax Purposes and Economic Depreciation on New Investment, 1946-1980

Year	Total:[a] Tax	Economic	Ratio (1)/(2)	Equipment: Tax	Economic	Ratio (1)/(2)	Structures: Tax	Economic	Ratio (1)/(2)
1946	0.767	0.551	1.39	0.795	0.697	1.14	0.730	0.358	2.04
1947	0.769	0.569	1.35	0.789	0.687	1.15	0.732	0.359	2.04
1948	0.769	0.567	1.36	0.791	0.691	1.14	0.732	0.356	2.06
1949	0.768	0.564	1.36	0.792	0.697	1.14	0.731	0.354	2.07
1950	0.773	0.579	1.34	0.795	0.706	1.13	0.734	0.357	2.06
1951	0.756	0.568	1.33	0.778	0.689	1.13	0.719	0.362	1.99
1952	0.752	0.565	1.33	0.774	0.685	1.13	0.716	0.367	1.95
1953	0.730	0.566	1.29	0.762	0.691	1.10	0.678	0.363	1.87
1954	0.784	0.568	1.38	0.817	0.694	1.18	0.730	0.364	2.00
1955	0.785	0.575	1.36	0.817	0.700	1.17	0.730	0.364	2.01
1956	0.768	0.563	1.37	0.802	0.688	1.16	0.713	0.359	1.99
1957	0.754	0.564	1.34	0.788	0.687	1.15	0.696	0.357	1.95
1958	0.761	0.553	1.38	0.802	0.685	1.17	0.698	0.350	1.99
1959	0.739	0.572	1.29	0.780	0.697	1.12	0.664	0.349	1.91
1960	0.738	0.567	1.30	0.780	0.693	1.13	0.663	0.346	1.92
1961	0.749	0.561	1.34	0.793	0.694	1.14	0.676	0.341	1.98
1962	0.756	0.566	1.34	0.806	0.698	1.15	0.671	0.338	1.98
1963	0.762	0.565	1.35	0.815	0.697	1.17	0.668	0.334	2.00
1964	0.764	0.568	1.34	0.819	0.696	1.18	0.663	0.334	1.98
1965	0.762	0.568	1.34	0.819	0.697	1.18	0.659	0.336	1.96
1966	0.745	0.572	1.30	0.803	0.696	1.15	0.636	0.339	1.88
1967	0.740	0.571	1.29	0.800	0.696	1.15	0.627	0.340	1.84
1968	0.732	0.575	1.27	0.797	0.703	1.13	0.609	0.333	1.83
1969	0.702	0.570	1.23	0.774	0.702	1.10	0.572	0.331	1.73
1970	0.667	0.561	1.19	0.756	0.695	1.09	0.516	0.332	1.56
1971	0.710	0.564	1.26	0.808	0.702	1.15	0.542	0.328	1.65
1972	0.728	0.568	1.28	0.827	0.706	1.17	0.552	0.323	1.71
1973	0.705	0.572	1.23	0.816	0.709	1.15	0.506	0.324	1.56
1974	0.688	0.577	1.19	0.799	0.707	1.13	0.484	0.336	1.44
1975	0.692	0.579	1.19	0.794	0.703	1.13	0.503	0.351	1.43
1976	0.705	0.590	1.20	0.801	0.710	1.13	0.518	0.353	1.47
1977	0.726	0.598	1.21	0.819	0.716	1.14	0.532	0.352	1.51
1978	0.699	0.593	1.18	0.802	0.720	1.11	0.504	0.351	1.44
1979	0.679	0.593	1.15	0.783	0.720	1.09	0.481	0.351	1.37
1980	0.645	0.593	1.09	0.753	0.720	1.05	0.438	0.351	1.25

a. The present value of capital consumption allowances is represented as a proportion of the original cost of the asset. Total is a weighted average for all 35 categories of investment. Equipment is a weighted average on 20 types of equipment. Structures is a weighted average on 15 types of structures.

U.S. tax law for an investment of one dollar in each year of the postwar period 1946-1980. Table 6 also provides data for investment in equipment and structures separately. We can compare the present value of capital consumption allowances on assets acquired in each year with the present values of economic depreciation on these assets.

The first two columns in Table 6 give the present values of capital consumption allowances for tax purposes and economic depreciation for all corporate investment. Capital consumption for tax purposes has exceeded economic depreciation in every year by amounts ranging from thirty-nine percent in 1946 at the beginning of the postwar period to nine percent in 1980 at the end of the period. We present similar comparisons for investment in equipment and structures in Table 6. We find that the present value of capital consumption allowances has exceeded economic depreciation on equipment by amounts ranging from five to eighteen percent. The present value of capital consumption allowances has exceeded economic depreciation on structures by amounts ranging from one hundred seven percent at the beginning of the period to twenty-five percent in 1980.

We have compared present values of capital consumption allowances for tax purposes and economic depreciation in Table 6. This comparison provides the appropriate measure of the impact of inflation on capital consumption allowances for new investment. A different perspective on the impact of inflation is provided by a comparison between capital consumption allowances claimed for tax purposes at historical and at replacement cost. We present such a comparison, based on our simulation model

for generating capital consumption allowances, in Table 7. For this purpose we employ simulated values of lifetimes and salvage values and relative proportions of assets depreciated by accelerated methods for all thirty-five types of assets listed in Table 1.

Since the rate of inflation in the prices of assets has been positive throughout the postwar period, except for 1958 and 1961, capital consumption allowances at historical cost have always fallen short of capital consumption at replacement cost. Historical cost capital consumption declined from seventy-three percent of replacement cost in 1946 to a postwar low of sixty-six percent in 1948. As inflation slowed during the 1950's and early 1960's, historical cost capital consumption rose relative to replacement cost, reaching a peak of ninety percent in 1965. The increase in the rate of inflation in the late 1960's and early 1970's resulted in a sizeable decline in the historical cost capital consumption relative to replacement cost capital consumption, reaching a trough of seventy-two percent in 1975.

We have compared capital consumption allowances for tax purposes at historical and at replacement cost in Table 7. We can provide an analogous comparison between economic depreciation at historical and at replacement cost. The results are given for each year of the period 1946-1978 in Table 8. At the beginning of the postwar period historical cost depreciation was seventy-six percent of replacement cost depreciation. As a consequence of the rapid inflation in the prices of assets during the period 1946-1948, the ratio of historical cost depreciation to replacement cost depreciation fell to seventy percent of 1948. This

Table 7

The Effect of Inflation on Corporate Capital Consumption Allowances for Tax Purposes, 1946-1978

Year	Simulated Corporate Capital Consumption Allowances: Historical Cost	Replacement[a] Cost	Ratio (1)/(2)	Percentage Change of Investment Price Deflator[b]
1946	4.82	6.57	0.73	11.3
1947	5.53	8.22	0.67	18.4
1948	6.49	9.78	0.66	9.6
1949	7.43	10.72	0.69	2.2
1950	8.37	11.70	0.72	3.1
1951	9.67	14.09	0.69	7.6
1952	11.24	15.73	0.71	2.1
1953	12.92	17.26	0.75	1.3
1954	14.84	19.08	0.78	0.8
1955	17.03	21.14	0.81	2.2
1956	19.10	24.45	0.78	5.5
1957	20.97	26.97	0.78	3.8
1958	22.35	28.05	0.80	-0.1
1959	23.64	29.23	0.81	1.2
1960	25.05	30.34	0.83	0.5
1961	26.38	31.08	0.85	-0.4
1962	30.50	35.27	0.86	0.5
1963	32.48	36.90	0.88	0.2
1964	34.72	38.98	0.89	0.8
1965	37.83	42.12	0.90	1.5
1966	41.25	46.23	0.89	3.3
1967	44.54	50.34	0.88	3.3
1968	48.51	55.44	0.88	4.3
1969	52.99	61.48	0.86	5.8
1970	56.64	67.07	0.84	4.8
1971	60.33	72.94	0.83	5.2
1972	66.15	79.57	0.83	4.3
1973	74.08	88.93	0.83	6.0
1974	82.31	105.48	0.78	10.7
1975	89.66	123.92	0.72	12.6
1976	97.20	133.65	0.73	5.6
1977	107.73	145.66	0.74	7.7
1978	122.26	164.36	0.74	9.2

a. Capital consumption allowances at replacement cost were calculated by multiplying the allowances for all assets by the ratio of the price deflator in each year to the price deflator in the year the asset was acquired.

b. Implicit price deflators corresponding to our 35 categories of investment were taken from the National Income and Product Accounts.

ratio began to rise gradually after 1948 as the rate of inflation declined, reaching a peak during the period 1964-1966 of ninety percent. This peak resulted from relatively low rates of inflation in asset prices during the period 1958-1964.

Rates of inflation in asset prices began to increase after 1964; by 1966 the ratio of historical cost depreciation to replacement cost depreciation began to decrease and fell to the postwar low of sixty-nine percent during the period 1975-1978. Comparing economic depreciation at historical and replacement cost in Table 8 with capital consumption allowances in Table 7, we find that the impact of inflation was very similar. High rates of inflation result in a cumulative divergence between historical and replacement cost capital consumption allowances. The pattern of divergence for economic depreciation is nearly identical.

The next step in our analysis of the impact of inflation on capital recovery under the U.S. corporate income tax is to compare the allowances claimed by U.S. corporations with economic depreciation at replacement cost. We find that capital consumption allowances were below economic depreciation from the beginning of the postwar period until 1962. The reduction in asset lifetimes allowed for tax purposes and the introduction of new accounting formulas for accelerated capital recovery in 1954 did not overcome the impact of rapid inflation during the early years of the postwar period. In 1962 the Depreciation Guidelines were introduced, making shorter lifetimes applicable to existing assets. As a consequence, capital consumption allowances for tax purposes overtook economic depreciation at replacement cost in 1962; the excess of capital consumption

Table 8

The Effect of Inflation on Corporate Economic Depreciation, 1946-1978

Year	Corporate Economic Depreciation		Ratio (1)/(2)	Percentage Change of Investment Price Deflator[c]
	Historical Cost[a]	Replacement Cost[b]		
1946	5.47	7.24	0.76	11.3
1947	6.47	9.18	0.70	18.4
1948	7.71	11.03	0.70	9.6
1949	8.81	12.09	0.73	2.2
1950	9.81	13.09	0.75	3.1
1951	10.91	15.24	0.72	7.6
1952	11.93	16.21	0.74	2.1
1953	12.97	16.99	0.76	1.3
1954	14.04	17.64	0.79	0.8
1955	15.17	18.68	0.80	2.2
1956	16.48	21.36	0.77	5.5
1957	17.94	23.31	0.77	3.8
1958	19.11	24.14	0.79	-0.1
1959	20.26	25.17	0.80	1.2
1960	21.66	26.28	0.82	0.5
1961	22.93	26.94	0.85	-0.4
1962	24.10	27.73	0.87	0.5
1963	25.46	28.79	0.88	0.2
1964	27.21	30.46	0.89	0.8
1965	29.61	32.92	0.90	1.5
1966	32.61	36.44	0.89	3.3
1967	35.68	40.21	0.89	3.3
1968	38.98	44.45	0.88	4.3
1969	42.68	49.62	0.86	5.8
1970	45.89	54.59	0.84	4.8
1971	49.11	59.77	0.82	5.2
1972	53.04	64.82	0.82	4.3
1973	58.43	71.74	0.81	6.0
1974	64.27	84.81	0.76	10.7
1975	69.78	100.06	0.70	12.8
1976	75.48	108.99	0.69	5.6
1977	82.97	119.63	0.69	7.7
1978	92.75	135.05	0.69	9.2

a. Economic depreciation at historical cost is calculated by applying Hulten-Wykoff depreciation rates to historical cost of acquisition of assets.

b. Economic depreciation at replacement cost is calculated by multiplying depreciation at historical cost for all assets by the ratio of the price deflator for each year to the price deflator in the year the asset was acquired.

c. Implicit price deflators used correspond to our 35 categories of investment. Price deflators were taken from the National Income and Product Accounts.

allowances over economic depreciation rose to fourteen percent in 1965. With increased rates of inflation beginning in 1965, the ratio of capital consumption allowances to economic depreciation began to decline, but remained above unity through 1973. In 1971 the Asset Depreciation Range System was introduced, further shortening lifetimes for tax purposes. Beginning in 1974 very high rates of inflation resulted in economic depreciation in excess of capital consumption allowances for tax purposes.

Our overall conclusion is that the present value of capital consumption allowances, based on expectations of inflation current at the time of investment, have exceeded the present value of economic depreciation throughout the postwar period, as indicated in Table 6. This is the reverse of the relationship between capital consumption allowances actually claimed by U.S. corporations and economic depreciation at replacement cost in Table 9 for the years 1946-1961 and 1974-1978. The difference is accounted for by the fact that increases in the rate of inflation have been entirely unanticipated.

Throughout the postwar period anticipated future inflation rates have been close to current rates of inflation, as indicated by the term structure of interest rates on U.S. government securities given in Table 5. Actual inflation rates have risen steadily since 1965, thereby exceeding the rates of inflation that were anticipated. As a consequence, the present value of capital consumption allowances at currently anticipated rates of inflation has exceeded the present value of economic depreciation. Actual capital consumption allowances claimed by U.S. corporations have fallen short of economic depreciation at replacement cost, except for the period 1962-1973.

Table 9

Corporate Capital Consumption Allowances for Tax Purposes and Economic Depreciation, 1946-1978

Year	Actual Corporate Capital Consumption Allowances[a]	Replacement Cost Corporate Economic Depreciation[b]	Ratio (1)/(2)
1946	4.59	7.24	0.63
1947	5.68	9.18	0.62
1948	6.82	11.03	0.62
1949	7.77	12.09	0.64
1950	8.50	13.09	0.65
1951	9.81	15.24	0.64
1952	11.10	16.21	0.68
1953	12.79	16.99	0.75
1954	14.50	17.84	0.81
1955	17.21	18.88	0.91
1956	18.90	21.36	0.88
1957	20.99	23.31	0.90
1958	22.23	24.14	0.92
1959	23.62	25.17	0.94
1960	25.25	26.28	0.96
1961	26.61	26.94	0.99
1962	30.41	27.73	1.10
1963	32.14	28.79	1.13
1964	34.57	30.46	1.13
1965	37.41	32.92	1.14
1966	40.61	36.44	1.11
1967	44.12	40.21	1.10
1968	48.09	44.45	1.08
1969	52.49	49.62	1.07
1970	56.61	54.59	1.04
1971	60.89	59.77	1.02
1972	67.89	64.52	1.05
1973	73.75	71.74	1.03
1974	81.61	84.81	0.96
1975	89.22	100.06	0.89
1976	97.12	108.90	0.89
1977	109.29	119.63	0.91
1978	119.81	135.05	0.89

a. Corporate capital consumption allowances based on Statistics of Income for corporations were prepared by Jerry Silverstein of the Bureau of Economic Analysis for this study.

b. Economic depreciation at replacement cost is calculated by multiplying depreciation at historical cost for all assets by the ratio of the price deflator in each year to the price deflator in the year the asset was acquired.

The final step is our analysis of the impact of inflation on capital recovery under U.S. tax law is to incorporate the offset to the cost of acquisition of assets provided by the investment tax credit. The investment tax credit was first adopted in 1962. It originally applied to equipment and certain special purpose structures. Under the Long Amendment the credit was subtracted from the cost of acquisition of assets in establishing the historical cost employed in calculating capital consumption allowances for tax purposes. This Amendment was repealed in 1964. The investment tax credit was suspended briefly in 1967-8, abolished in 1969, and re-instituted in 1971. During the period from 1962 to 1974 the definition of special purpose structures was gradually broadened.

In 1975 the investment tax credit was made permanent; the statutory rate was raised from seven to ten percent for most assets and from four to ten percent for public utility assets. The credit was made applicable to a large proportion of structures as well as equipment. As much as fifty-seven percent of the cost of acquisition of structures in 1975 was covered by the investment tax credit. Effective rates of the investment tax credit for all of investment for equipment and structures separately are given in Table 10 for the period 1962 to 1980. These rates are based on estimates of effective rates for each of the thirty-four types of assets presented in Table 1. The effective rates by type of asset are weighted by actual investment in each type of asset in each year to obtain averages for equipment and structures.

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Table 10

Effective Rates of the Investment Tax Credit, 1962-1980

Year	Investment Tax Credit[a]		
	Total	Equipment	Structures
1962	0.034	0.054	0.000
1963	0.036	0.055	0.002
1964	0.037	0.055	0.005
1965	0.037	0.056	0.003
1966	0.030	0.043	0.004
1967	0.033	0.046	0.009
1968	0.038	0.054	0.009
1969	0.011	0.015	0.002
1970	0.000	0.000	0.000
1971	0.028	0.040	0.007
1972	0.037	0.053	0.009
1973	0.037	0.052	0.009
1974	0.038	0.053	0.011
1975	0.062	0.074	0.040
1976	0.070	0.081	0.049
1977	0.069	0.079	0.048
1978	0.067	0.078	0.044
1979	0.067	0.078	0.044
1980	0.067	0.078	0.044

a. Effective rates of the investment tax credit are averages of effective rates calculated separately for each category of investment, based on methods developed independently by Corcoran (1979) and Jeremias (1979). Estimates of the amount of property covered by the investment credit are derived from Statistics of Income. The applicable statutory credit rates are weighted by these amounts in each category. Public utility property before 1975 and shorter-lived assets are eligible for only a fraction of the full rate. Effective rates are also less than the statutory rate due to considerable carryover. In certain years the credit was available only part of the year.

4. Capital Recovery During the Postwar Period

The objective of our analysis of capital recovery under U.S. tax law during the postwar period 1946-1980 is to estimate effective tax rates for equipment and structures acquired by U.S. corporations during this period. We recall from the discussion of Section 1 that the investment tax credit is a direct offset against tax liability, while capital consumption allowances are a deduction from taxable income. The effective tax rate for an asset depends on the statutory tax rate, the effective rate of the investment tax credit, the present value of capital consumption allowances for tax purposes, the rate of economic depreciation, and the rate of return after taxes, corrected for inflation.

We present effective tax rates for all corporate investment for each year in the postwar period 1946-1980 in Table 11. We also present effective tax rates for structures and for equipment separately. If capital consumption allowances were equal to economic depreciation and the investment tax credit were equal to zero for all assets, the effective tax rate would be the same for all assets and equal to the statutory rate. We present the statutory tax rate in Table 11 as a basis for comparison with the effective tax rates under U.S. tax law. We find that the effective tax rate was below the statutory rate in every year. The ratio of the effective tax rate to the statutory rate is given in the final column of Table 11.

Table 11

Effective Corporate Tax Rates, 1946-1980

Year	Effective Corporate Tax Rate[a]			Statutory Tax Rate	Ratio (1)/(4)
	Total	Equipment	Structures		
1946	0.258	0.301	0.207	0.380	0.680
1947	0.265	0.301	0.201	0.380	0.697
1948	0.264	0.302	0.200	0.380	0.696
1949	0.266	0.307	0.200	0.380	0.699
1950	0.303	0.346	0.226	0.420	0.720
1951	0.399	0.436	0.310	0.510	0.762
1952	0.398	0.445	0.322	0.520	0.766
1953	0.418	0.460	0.348	0.520	0.803
1954	0.366	0.400	0.312	0.520	0.704
1955	0.370	0.405	0.311	0.520	0.712
1956	0.379	0.411	0.325	0.520	0.728
1957	0.394	0.429	0.335	0.520	0.758
1958	0.377	0.408	0.330	0.520	0.725
1959	0.412	0.444	0.355	0.520	0.792
1960	0.411	0.442	0.356	0.520	0.790
1961	0.397	0.428	0.346	0.520	0.764
1962	0.285	0.250	0.345	0.520	0.548
1963	0.265	0.219	0.344	0.520	0.509
1964	0.237	0.189	0.324	0.500	0.474
1965	0.213	0.160	0.309	0.480	0.444
1966	0.274	0.247	0.324	0.480	0.570
1967	0.269	0.240	0.323	0.480	0.560
1968	0.259	0.221	0.330	0.480	0.539
1969	0.372	0.378	0.361	0.480	0.776
1970	0.416	0.429	0.394	0.480	0.867
1971	0.289	0.244	0.367	0.480	0.603
1972	0.229	0.157	0.357	0.480	0.478
1973	0.257	0.188	0.383	0.480	0.536
1974	0.281	0.221	0.394	0.480	0.586
1975	0.206	0.131	0.345	0.480	0.430
1976	0.161	0.081	0.320	0.480	0.336
1977	0.128	0.041	0.308	0.480	0.266
1978	0.180	0.099	0.335	0.480	0.376
1979	0.192	0.121	0.327	0.460	0.418
1980	0.243	0.195	0.352	0.460	0.528

a. Effective tax rates are weighted averages of effective tax rates calculated for each category of investment. An after-tax rate of return corrected for inflation of .0606 is used. This is equal to the average rate of return after corporate taxes in the 1946-1978 period, based on the results of Christensen and Jorgenson (1978). Present values of capital consumption allowances for tax purposes and economic depreciation correspond to those of Table 6. Effective rates of the investment tax credit correspond to those of Table 10.

We find that the ratio of the effective tax rate on corporate investment to the statutory rate fluctuated between sixty-eight and eighty percent over the period from 1946 to 1961. When the investment tax credit was first adopted in 1962, the ratio of the effective tax rate to the statutory rate dropped to fifty-five percent in that year from seventy-six percent in 1961. When the investment tax credit was repealed in 1969 and 1970, the effective tax rate climbed to seventy-eight percent of the statutory rate in 1969 and to eighty-seven percent of the statutory rate in 1970. Reinstitution of the investment tax credit in 1971 reduced the effective tax rate to sixty percent of the statutory rate in that year and forty-eight percent in the following year. Liberalization of the investment tax credit in 1975 reduced the effective tax rate to forty-three percent of the statutory rate. The effective tax rate fell to 12.8 percent in 1977 as the rate of inflation decreased and rose to 24.3 percent in 1980 as the rate of inflation increased.

Our first conclusion is that the effective tax rate under U.S. tax law has been below the statutory tax rate throughout the postwar period 1946-1980. The effect of inflation under any given set of tax provisions for capital recovery is to increase the effective tax rate. This occurs through an increase in the discount rates applied to future capital consumption allowances, as indicated in Table 5. However, tax provisions have been revised at frequent intervals with major revisions in 1954, 1962, 1970, and 1975. The impact of these revisions has been to reduce effective tax rates very dramatically, especially in 1962 with the adoption of the investment tax credit and the Depreciation Guidelines and in 1975 with the liberalization of the investment tax credit.

Since the effective tax rate increases with the rate of inflation, a decrease in the rate of inflation to levels below those prevailing since 1973 would reduce the effective tax rate substantially. The decrease in the rates of inflation in the prices of assets from 12.8 percent in 1975 to 5.6 in 1976 and 7.7 in 1977 brought the effective tax rate down to a level of 16.1 percent in 1976 and 12.8 percent in 1977. These tax rates can be compared with the statutory rate of forty-eight percent in both years. The increases in the rate of inflation in 1978, 1979, and 1980 brought effective tax rates up to 18.0 percent in 1978, 19.2 percent in 1979, and 24.3 percent in 1980.

Our second conclusion is that the U.S. corporate income tax imposes significantly different effective tax rates on different assets, resulting in serious misallocations of capital. Effective tax rates for equipment and structures have been substantially different through the postwar period. Until 1962 effective tax rates for structures were below those of equipment by eight to twelve percent. After the introduction of the investment tax credit in 1962 the effective tax rate on equipment fell below that of structures by ten percent in that year. After the liberalization of the investment tax credit in 1975 the gap between effective tax rates for equipment and structures rose to twenty-one percent in that year and reached a maximum of twenty-seven percent in 1977. Differences in tax rates among assets increase with a decrease in the rate of inflation, resulting in greater misallocations of capital.

Differences in effective tax rates among assets result in differences in social rates of return on these assets. The gap between social

rates of return on equipment and structures creates the opportunity for gains in future output at no sacrifice of consumption either now or in the future. For any given asset the social rate of return ρ, corrected for inflation and for taxes paid at the effective tax rate e, is equal to the private rate of return r, corrected for inflation and for taxes paid at the statutory rate u:

$$(1-e)\,\rho = (1-u)\,r\ .$$

We can denote effective tax rates on equipment and structures by e_E and e_S; the corresponding difference in social rates of return, say ρ_E and ρ_S is given by:

$$\rho_S - \rho_E = \left(\frac{1}{1-e_S} - \frac{1}{1-e_E}\right) (1-u)\,r\ .$$

Considering the effective tax rates in 1977 of 4.1 percent for equipment and 30.8 percent for structures, we find that the difference in social rates of return is 2.44 percent. This implies that the social rate of return to the transfer of one dollar's worth of investment from equipment to structures in 1977 would have been 2.44 percent per year. This can be compared with the private rate of return of 6.06 percent per year for the postwar period as a whole. To gain perspective on the gap between social rates of return that existed in 1977 we can consider the value of an investment at this rate of return in 1946. By 1956 this investment, corrected for inflation, would have been worth $1.27.

By 1966 the investment would have been worth $1.62. By 1976 the investment would have been worth $2.06 and by 1981 the investment would have been worth $2.33. The returns of $.27 by 1956, $.62 by 1966, $1.06 by 1976 and $1.33 by 1981 for each dollar's worth of investment correspond to costless increases in the national wealth that would be available for consumption or additional investment.

In Table 12 we present estimates of effective tax rates for the thirty-five types of assets listed in Table 1. We give these effective tax rates for six business cycle peak years during this period -- 1953, 1957, 1960, 1966, 1973, and 1979. The discount rates applied to future capital consumption allowances have increased steadily from peak to peak throughout the postwar period. For each type of assets we present the present value of capital consumption allowances for tax purposes, the effective rate of the investment tax credit, and the effective tax rate. Differences in effective tax rates are much greater among the thirty-five types of assets given in Table 12 than between equipment and structures given in Table 11.

The gap among effective tax rates for different assets in 1953 was a maximum for autos with an effective tax rate of fifty-eight percent and mining and and exploration structures, shafts and wells of twenty-nine percent. The gap of twenty-nine percent equals the maximum gap between equipment and structures for the postwar period. The gap between effective tax rates for these two assets was also a maximum for 1957 at twenty-six percent and for 1960 at twenty-five percent.

Table 12

Effective Corporate Tax Rate by Type of Asset, Selected Years: 1953, 1957

	1953			1957		
Asset	Present Value	ITC	Effective Tax Rate	Present Value	ITC	Effective Tax Rate
1	0.751	0.00	0.43	0.776	0.00	0.41
2	0.720	0.00	0.43	0.749	0.00	0.41
3	0.691	0.00	0.43	0.721	0.00	0.41
4	0.825	0.00	0.41	0.846	0.00	0.38
5	0.730	0.00	0.43	0.756	0.00	0.41
6	0.813	0.00	0.44	0.836	0.00	0.41
7	0.801	0.00	0.44	0.825	0.00	0.41
8	0.740	0.00	0.46	0.766	0.00	0.43
9	0.740	0.00	0.43	0.766	0.00	0.41
10	0.760	0.00	0.44	0.785	0.00	0.41
11	0.625	0.00	0.51	0.646	0.00	0.48
12	0.801	0.00	0.44	0.825	0.00	0.41
13	0.760	0.00	0.43	0.785	0.00	0.41
14	0.813	0.00	0.51	0.836	0.00	0.49
15	0.801	0.00	0.58	0.825	0.00	0.55
16	0.813	0.00	0.45	0.836	0.00	0.42
17	0.681	0.00	0.44	0.714	0.00	0.41
18	0.650	0.00	0.44	0.689	0.00	0.41
19	0.791	0.00	0.44	0.815	0.00	0.41
20	0.791	0.00	0.44	0.815	0.00	0.41
21	0.683	0.00	0.35	0.703	0.00	0.34
22	0.600	0.00	0.38	0.633	0.00	0.36
23	0.519	0.00	0.41	0.557	0.00	0.39
24	0.519	0.00	0.41	0.557	0.00	0.39
25	0.519	0.00	0.42	0.557	0.00	0.40
26	0.639	0.00	0.41	0.671	0.00	0.38
27	0.502	0.00	0.41	0.540	0.00	0.39
28	0.683	0.00	0.35	0.703	0.00	0.33
29	0.650	0.00	0.36	0.680	0.00	0.34
30	0.650	0.00	0.36	0.680	0.00	0.34
31	0.694	0.00	0.37	0.711	0.00	0.35
32	0.586	0.00	0.38	0.619	0.00	0.36
33	0.805	0.00	0.29	0.802	0.00	0.29
34	0.639	0.00	0.37	0.671	0.00	0.35
35	0.616	0.00	0.34	0.647	0.00	0.32

Table 12 (continued)

Effective Corporate Tax Rate by Type of Asset, Selected Years: 1960, 1966

Asset	1960 Present Value	1960 ITC	1960 Effective Tax Rate	1966 Present Value	1966 ITC	1966 Effective Tax Rate
1	0.763	0.00	0.42	0.797	0.05	0.20
2	0.732	0.00	0.42	0.770	0.04	0.26
3	0.704	0.00	0.42	0.740	0.03	0.29
4	0.841	0.00	0.39	0.822	0.02	0.33
5	0.742	0.00	0.42	0.790	0.05	0.20
6	0.829	0.00	0.42	0.809	0.05	0.24
7	0.817	0.00	0.42	0.820	0.05	0.20
8	0.751	0.00	0.45	0.767	0.05	0.26
9	0.751	0.00	0.42	0.773	0.05	0.23
10	0.772	0.00	0.43	0.803	0.05	0.21
11	0.841	0.00	0.49	0.814	0.05	0.29
12	0.817	0.00	0.42	0.815	0.05	0.22
13	0.772	0.00	0.42	0.784	0.04	0.25
14	0.829	0.00	0.49	0.865	0.03	0.28
15	0.817	0.00	0.56	0.890	0.02	0.31
16	0.829	0.00	0.43	0.860	0.03	0.20
17	0.694	0.00	0.43	0.717	0.05	0.27
18	0.669	0.00	0.43	0.721	0.05	0.25
19	0.806	0.00	0.42	0.809	0.05	0.22
20	0.806	0.00	0.42	0.811	0.05	0.21
21	0.678	0.00	0.36	0.649	0.00	0.34
22	0.605	0.00	0.38	0.526	0.00	0.38
23	0.527	0.00	0.40	0.504	0.00	0.37
24	0.527	0.00	0.40	0.504	0.00	0.37
25	0.527	0.00	0.42	0.504	0.00	0.39
26	0.642	0.00	0.40	0.622	0.00	0.38
27	0.509	0.00	0.41	0.581	0.01	0.32
28	0.678	0.00	0.35	0.657	0.01	0.32
29	0.652	0.00	0.36	0.650	0.01	0.31
30	0.652	0.00	0.36	0.669	0.01	0.30
31	0.685	0.00	0.37	0.692	0.01	0.32
32	0.590	0.00	0.38	0.640	0.02	0.29
33	0.784	0.00	0.31	0.847	0.01	0.18
34	0.642	0.00	0.36	0.606	0.02	0.32
35	0.620	0.00	0.33	0.592	0.00	0.31

Table 12 (concluded)

Effective Corporate Tax Rate by Type of Asset, Selected Years: 1973, 1979

Asset	1973 Present Value	1973 ITC	1973 Effective Tax Rate	1979 Present Value	1979 ITC	1979 Effective Tax Rate
1	0.813	0.06	0.13	0.773	0.09	0.06
2	0.774	0.06	0.20	0.728	0.09	0.13
3	0.730	0.04	0.29	0.680	0.09	0.19
4	0.883	0.04	0.08	0.849	0.06	0.05
5	0.813	0.06	0.11	0.773	0.09	0.06
6	0.810	0.06	0.19	0.773	0.09	0.08
7	0.818	0.06	0.14	0.780	0.09	0.06
8	0.776	0.06	0.20	0.724	0.09	0.16
9	0.776	0.06	0.18	0.724	0.09	0.15
10	0.813	0.06	0.15	0.773	0.09	0.06
11	0.805	0.06	0.25	0.751	0.09	0.19
12	0.810	0.06	0.18	0.767	0.09	0.09
13	0.781	0.05	0.24	0.730	0.09	0.15
14	0.889	0.03	0.18	0.865	0.05	0.13
15	0.929	0.02	0.14	0.908	0.03	0.12
16	0.860	0.06	0.07	0.819	0.08	0.00
17	0.694	0.06	0.26	0.644	0.09	0.23
18	0.739	0.06	0.20	0.686	0.09	0.17
19	0.805	0.06	0.19	0.763	0.09	0.10
20	0.813	0.06	0.15	0.769	0.09	0.08
21	0.514	0.00	0.42	0.437	0.00	0.43
22	0.372	0.00	0.45	0.304	0.00	0.45
23	0.370	0.00	0.43	0.302	0.00	0.44
24	0.370	0.00	0.43	0.302	0.00	0.44
25	0.370	0.00	0.45	0.302	0.00	0.45
26	0.495	0.00	0.45	0.421	0.00	0.46
27	0.504	0.02	0.35	0.428	0.09	0.29
28	0.534	0.02	0.38	0.458	0.09	0.31
29	0.534	0.02	0.37	0.458	0.09	0.30
30	0.566	0.02	0.35	0.491	0.09	0.28
31	0.593	0.02	0.37	0.518	0.09	0.30
32	0.558	0.04	0.31	0.482	0.09	0.27
33	0.841	0.03	0.15	0.793	0.06	0.11
34	0.528	0.04	0.34	0.447	0.09	0.31
35	0.503	0.00	0.36	0.446	0.00	0.36

By 1966 the maximum effective tax rate for any asset had shifted to hospital buildings at thirty-nine percent. The gap between effective tax rates for hospitals and for mining and exploration structures, shafts and wells was only twenty-one percent. By 1973 the minimum effective tax rate had shifted to aircraft at only seven percent. The gap between effective tax rates for aircraft and for hospital buildings was thirty-eight percent. The maximum gap rose to forty-six percent in 1979, when the effective tax rate on aircraft dropped to zero and the rate on other nonfarm buildings rose to forty-six percent.

A difference between effective tax rates of forty-six percent in 1979 corresponds to a difference between social rates of return of 5.16 percent. As before, it is useful to put the gap between social rates of return that existed in 1979 in perspective by considering the value of an investment at this rate of return beginning in 1946. The investment would have worth $1.65 in 1956 and $2.74 in 1966, both corrected for inflation. By 1976 the value of the investment would have grown to $3.93 and by 1981 the investment would have grown to $4.94, again corrected for inflation. We conclude that the loss in efficiency of capital allocation due to differences in effective tax rates among assets in 1979 was very large. It is important to emphasize that gaps among social rates of return would increase with a decrease in the rate of inflation.

To measure the burden of taxation on individual industries and differences in tax burdens among industries we have calculated effective tax rates by industry for the forty-four industries listed in Table 13. For each industry we have compiled data on the composition of investment by type of asset for each year of the postwar period 1946-1980.[8] Using the relative proportions of investment among assets as weights we have calculated effective tax rates for equipment, structures and total investment in each industry in each year. We present the results in Table 14 for the business cycle peaks 1953, 1957, 1960, 1966, 1973 and 1979. Differences in effective tax rates among industries given in Table 14 are less than differences in these rates among assets given in Table 12. Effective tax rates for individual industries are essentially averages of rates for all assets with weights that differ among industries.

The gap between effective tax rates for different industries in 1953 was a maximum for street railway, bus lines, and taxicab service with an effective tax rate of fifty-six percent and crude petroleum and natural gas extraction of thirty-two percent. The gap between effective tax rates for these two industries was also a maximum for 1957 and 1960 at nineteen percent in each year. By 1966 the maximum effective tax rate for any industry had shifted to finance, insurance, and real estate at thirty-three percent while the minimum rate had shifted to air transportation at twenty percent. By 1973 the maximum effective tax rate was for pipelines, except natural gas, at thirty-six percent; the minimum was for air transportation at eight percent. By 1979 the effective tax rate for

Table 13

Industries

1. Food and kindred products
2. Tobacco manufacturers
3. Textile mill products
4. Apparel and other fabricated textile products
5. Paper and allied products
6. Printing, publishing, and allied industries
7. Chemicals and allied products
8. Petroleum and coal products
9. Rubber and miscellaneous plastic products
10. Leather and leather products
11. Lumber and wood products, except furniture
12. Furniture and fixtures
13. Stone, clay, and glass products
14. Primary metal industries
15. Fabricated metal industries
16. Machinery except electrical
17. Electrical machinery, equipment, and supplies
18. Transportation equipment, except motor vehicles, and ordnance
19. Motor vehicles, and motor vehicle equipment
20. Professional photographic equipment and watches
21. Miscellaneous manufacturing industries
22. Agricultural production
23. Agricultural services, horticultural services, forestry and fisheries
24. Metal mining
25. Coal mining
26. Crude petroleum and natural gas extraction
27. Nonmetallic mining and quarrying, except fuel
28. Construction
29. Railroads and railway express service
30. Street railway, bus lines and taxicab service
31. Trucking service, warehousing and storage
32. Water transportation
33. Air transportation
34. Pipelines, except natural gas
35. Services incidental to transportation
36. Telephone, telegraph, and miscellaneous communication services
37. Radio broadcasting and television
38. Electric utilities
39. Gas utilities
40. Water supply, sanitary services, and other utilities
41. Wholesale trade
42. Retail trade
43. Finance, insurance and real estate
44. Services

Table 14

Effective Corporate Tax Rate by Industry, Selected Years

Industry	Effective Tax Rates, 1953[a]			Effective Tax Rates, 1957[a]		
	Total	Equipment	Structures	Total	Equipment	Structures
1	0.43	0.46	0.36	0.41	0.43	0.34
2	0.43	0.45	0.37	0.41	0.42	0.34
3	0.42	0.44	0.36	0.40	0.42	0.34
4	0.44	0.46	0.36	0.42	0.43	0.34
5	0.42	0.44	0.35	0.40	0.42	0.34
6	0.42	0.45	0.36	0.40	0.43	0.34
7	0.42	0.45	0.35	0.40	0.42	0.34
8	0.39	0.45	0.35	0.37	0.42	0.34
9	0.44	0.46	0.35	0.41	0.43	0.34
10	0.43	0.45	0.36	0.41	0.42	0.34
11	0.43	0.46	0.35	0.42	0.44	0.34
12	0.43	0.47	0.35	0.40	0.44	0.34
13	0.43	0.46	0.36	0.40	0.43	0.34
14	0.42	0.45	0.35	0.40	0.42	0.34
15	0.43	0.46	0.35	0.41	0.43	0.34
16	0.43	0.47	0.36	0.40	0.43	0.34
17	0.43	0.46	0.36	0.40	0.43	0.34
18	0.42	0.47	0.36	0.39	0.43	0.34
19	0.45	0.47	0.36	0.42	0.43	0.34
20	0.43	0.47	0.35	0.40	0.44	0.34
21	0.44	0.47	0.36	0.40	0.43	0.34
22	0.46	0.47	0.38	0.43	0.43	0.36
23	0.46	0.47	0.38	0.43	0.43	0.36
24	0.42	0.44	0.41	0.39	0.41	0.37
25	0.44	0.44	0.38	0.40	0.41	0.35
26	0.32	0.45	0.29	0.33	0.42	0.31
27	0.44	0.44	0.39	0.41	0.42	0.36
28	0.45	0.45	0.39	0.43	0.43	0.36
29	0.43	0.44	0.41	0.41	0.41	0.39
30	0.56	0.56		0.52	0.52	
31	0.50	0.50		0.47	0.47	
32	0.44	0.44		0.41	0.41	
33	0.45	0.45		0.42	0.42	
34	0.38	0.43	0.37	0.35	0.41	0.35
35	0.49	0.49	0.38	0.46	0.46	0.36
36	0.40	0.43	0.35	0.38	0.41	0.33
37	0.43	0.43	0.41	0.40	0.41	0.37
38	0.39	0.44	0.36	0.37	0.41	0.34
39	0.37	0.44	0.36	0.34	0.41	0.34
40	0.37	0.44	0.37	0.35	0.41	0.35
41	0.46	0.47	0.38	0.43	0.44	0.36
42	0.46	0.47	0.38	0.43	0.44	0.36
43	0.38	0.49	0.38	0.36	0.46	0.36
44	0.46	0.48	0.39	0.43	0.44	0.37

a. Absence of effective tax rates for structures implies that there was no investment in structures in the corresponding industry.

Table 14 (continued)

Effective Corporate Tax Rate by Industry, Selected Years

Industry	Effective Tax Rates 1960 [a]			Effective Tax Rates 1966 [a]		
	Total	Equipment	Structures	Total	Equipment	Structures
1	0.43	0.45	0.36	0.27	0.24	0.34
2	0.41	0.44	0.36	0.25	0.22	0.34
3	0.42	0.43	0.36	0.26	0.24	0.34
4	0.42	0.44	0.36	0.27	0.24	0.34
5	0.42	0.43	0.36	0.25	0.24	0.34
6	0.41	0.44	0.36	0.28	0.24	0.34
7	0.42	0.43	0.36	0.26	0.24	0.34
8	0.38	0.44	0.36	0.30	0.25	0.34
9	0.43	0.45	0.36	0.26	0.25	0.34
10	0.42	0.44	0.36	0.27	0.24	0.34
11	0.43	0.45	0.36	0.28	0.26	0.34
12	0.42	0.45	0.36	0.28	0.25	0.34
13	0.42	0.44	0.36	0.27	0.25	0.34
14	0.42	0.44	0.36	0.26	0.24	0.34
15	0.43	0.45	0.36	0.27	0.25	0.34
16	0.43	0.45	0.36	0.28	0.26	0.34
17	0.42	0.44	0.36	0.27	0.25	0.34
18	0.42	0.45	0.36	0.28	0.25	0.34
19	0.43	0.45	0.36	0.27	0.25	0.34
20	0.43	0.45	0.36	0.29	0.26	0.34
21	0.43	0.45	0.36	0.28	0.25	0.34
22	0.44	0.44	0.38	0.26	0.26	0.29
23	0.44	0.44	0.36	0.26	0.26	0.29
24	0.40	0.42	0.39	0.32	0.22	0.35
25	0.41	0.42	0.36	0.23	0.22	0.32
26	0.35	0.43	0.34	0.26	0.22	0.26
27	0.42	0.43	0.38	0.24	0.22	0.36
28	0.44	0.44	0.38	0.24	0.24	0.38
29	0.43	0.43	0.41	0.25	0.25	0.32
30	0.54	0.54	0.36	0.29	0.29	0.34
31	0.47	0.47	0.36	0.27	0.27	0.34
32	0.43	0.43		0.27	0.27	0.00
33	0.43	0.43	0.39	0.20	0.20	0.38
34	0.37	0.42	0.37	0.32	0.27	0.32
35	0.47	0.47	0.38	0.27	0.26	0.38
36	0.39	0.42	0.35	0.27	0.25	0.32
37	0.41	0.42	0.40	0.30	0.25	0.38
38	0.38	0.42	0.36	0.29	0.25	0.31
39	0.36	0.42	0.36	0.30	0.25	0.30
40	0.36	0.42	0.36	0.32	0.25	0.32
41	0.44	0.45	0.38	0.26	0.24	0.38
42	0.43	0.45	0.38	0.28	0.24	0.38
43	0.38	0.47	0.38	0.34	0.26	0.37
44	0.43	0.45	0.38	0.28	0.24	0.38

a. Absence of effective tax rates for structures implies that there was no investment in structures in the corresponding industry.

Table 14 (concluded)

Effective Corporate Tax Rate by Industry, Selected Years

Industry	Effective Tax Rates 1973[a]			Effective Tax Rates 1979		
	Total	Equipment	Structures	Total	Equipment	Structures
1	0.24	0.18	0.42	0.20	0.12	0.43
2	0.26	0.16	0.42	0.15	0.09	0.43
3	0.23	0.19	0.42	0.19	0.14	0.43
4	0.26	0.19	0.42	0.23	0.14	0.43
5	0.22	0.19	0.42	0.16	0.13	0.43
6	0.23	0.18	0.42	0.19	0.14	0.43
7	0.23	0.19	0.42	0.17	0.12	0.43
8	0.29	0.20	0.42	0.26	0.13	0.43
9	0.24	0.19	0.42	0.20	0.14	0.43
10	0.26	0.19	0.42	0.24	0.15	0.43
11	0.23	0.18	0.42	0.18	0.12	0.43
12	0.28	0.18	0.42	0.24	0.13	0.43
13	0.23	0.18	0.42	0.18	0.12	0.43
14	0.23	0.19	0.42	0.18	0.13	0.43
15	0.24	0.19	0.42	0.21	0.14	0.43
16	0.25	0.20	0.42	0.22	0.15	0.43
17	0.25	0.21	0.42	0.20	0.14	0.43
18	0.26	0.19	0.42	0.21	0.13	0.43
19	0.22	0.19	0.42	0.16	0.13	0.43
20	0.27	0.20	0.42	0.22	0.15	0.43
21	0.26	0.19	0.42	0.22	0.14	0.43
22	0.14	0.12	0.31	0.08	0.07	0.27
23	0.13	0.12	0.31	0.08	0.07	0.27
24	0.34	0.18	0.43	0.30	0.07	0.42
25	0.20	0.17	0.35	0.10	0.07	0.32
26	0.28	0.17	0.28	0.12	0.07	0.13
27	0.19	0.17	0.44	0.09	0.07	0.44
28	0.19	0.18	0.45	0.10	0.08	0.44
29	0.21	0.20	0.35	0.18	0.17	0.29
30	0.16	0.16	0.42	0.13	0.12	0.43
31	0.18	0.18	0.42	0.13	0.13	0.43
32	0.26	0.26	0.00	0.23	0.23	0.43
33	0.08	0.08	0.45	0.00	0.00	0.45
34	0.36	0.22	0.37	0.29	0.13	0.30
35	0.19	0.18	0.45	0.13	0.12	0.45
36	0.28	0.23	0.38	0.19	0.15	0.31
37	0.32	0.24	0.45	0.25	0.15	0.46
38	0.32	0.22	0.37	0.23	0.13	0.30
39	0.34	0.22	0.35	0.25	0.13	0.28
40	0.34	0.22	0.34	0.30	0.13	0.31
41	0.24	0.17	0.45	0.15	0.11	0.45
42	0.28	0.17	0.45	0.23	0.11	0.45
43	0.31	0.20	0.44	0.24	0.13	0.44
44	0.26	0.18	0.45	0.18	0.10	0.45

a. Absence of effective tax rates for structures implies that there was no investment in structures in the corresponding industry.

air transportation had dropped to zero, while the effective tax rate for metal mining and water supply, sanitary services, and other utilities was a maximum among industries at thirty percent.

Our analysis of effective tax rates by type of asset and by industry corroborates the conclusions we reached on the basis of effective tax rates for U.S. corporations as a whole. Only one industry -- street railways, bus lines, and taxicab service in 1953 and 1960 -- has had effective tax rates in excess of the statutory tax rate for any year in the postwar period. Similarly, only one asset -- autos in 1953, 1957, and 1960 -- had an effective tax rate in excess of the statutory rate. For all other industries and all other assets the effective tax rates under U.S. law has been below the statutory tax rate throughout the postwar period. The impact of tax revisions has been to reduce effective tax rates very dramatically for all assets and all industries. However, effective tax rates under current law increase with a decrease in the rate of inflation.

Our analysis of differences in effective tax rates among types of assets and among industries reveals larger differences than those between equipment and structures for all U.S. corporations. Differences between effective tax rates correspond to gaps between social rates of return among assets and industries. These gaps present opportunities for costless increases in the national wealth that would be available for consumption or additional investment. The gaps are very large, indicating that there is a substantial loss in efficiency in the allocation of capital under U.S. tax law. It is important to reiterate that differences in effective tax rates among assets and industries would increase with a decrease in the rate of inflation.

5. Proposed Systems for Capital Recovery

The objective of our analysis of alternative systems for capital recovery under U.S. tax law is to estimate effective tax rates for assets acquired by U.S. corporations to the future. We consider the provisions of current law as a starting point for a comparison among alternative systems. We also consider two specific alternatives under consideration by the Congress -- the Reagan Administration proposal and the Senate Finance Committee proposal.[9] Finally, we consider expensing of the costs of acquisition of assets and the deduction of economic depreciation from income for tax purposes as possible approaches to capital recovery under U.S. law.

The present value of capital consumption allowances under immediate expensing of acquisition costs of assets is equal to unity for all assets. We have estimated present values of capital consumption allowances for tax purposes for each of the thirty-five types of assets presented in Table 1 under current law and under each of the three alternative proposals we have listed above. We have also estimated the present value of economic depreciation on the basis of data on the rate of depreciation and the after tax rate of return, corrected for inflation. For current law, for the two alternative proposals, and for economic depreciation, we have weighted the present values of actual investment to obtain average present values for equipment, structures, and total investment. We present the results of our calculations in Table 15.

Table 15

Present Values of Corporate Capital Consumption Allowances for Tax Purposes on New Investment

Discount Factors	Policy	Present Values Equipment	Structures	Total	Ratio Tax to Economic	Yield on 10- year Security
1960	Current	0.886	0.641	0.801	1.351	4.13
	Reagan	0.941	0.823	0.900	1.518	4.13
	Senate	0.941	0.760	0.879	1.482	4.13
1966	Current	0.867	0.611	0.779	1.314	4.86
	Reagan	0.927	0.803	0.885	1.492	4.86
	Senate	0.927	0.735	0.861	1.452	4.86
1973	Current	0.831	0.525	0.725	1.223	6.73
	Reagan	0.907	0.758	0.855	1.442	6.73
	Senate	0.907	0.669	0.825	1.391	6.73
1980	Current	0.754	0.418	0.638	1.076	11.16
	Reagan	0.856	0.672	0.792	1.336	11.16
	Senate	0.857	0.563	0.756	1.275	11.16
1980 Plus Four Percent	Current	0.696	0.352	0.578	0.974	15.16
	Reagan	0.815	0.610	0.745	1.256	15.16
	Senate	0.819	0.492	0.706	1.191	15.16

Under present U.S. tax law and under the two alternative proposals for more rapid capital recovery, capital consumption allowances are based on the historical cost of acquisition of an asset. We have calculated present values of these allowances under currently anticipated rates of inflation, based on the term structure for government securities for 1980 given in Table 5. Since anticipated rates of inflation may be higher or lower in the future, we have also calculated present values under anticipated rates of inflation for 1960, 1966, and 1973 -- all of which involved lower anticipated rates of inflation than 1980. We have also added four percent to the yields on government securities for 1980 to obtain hypothetical values of anticipated rates of inflation that are higher than those in 1980.

In characterizing provisions for capital recovery under present law we have assumed that asset lifetimes, scrap values, and accounting formulas for tax purposes will remain the same as those for 1980. We find that at currently anticipated rates of inflation, present law provides capital consumption for tax purposes that exceed economic depreciation by 7.6 percent. The excess over economic depreciation would rise to 22.3 percent at anticipated rates of inflation of 1973, 31.4 percent at rates for 1966, and 35.1 percent at rates for 1960. If anticipated rates of inflation were to increase by four percent over currently anticipated rates, the present value of capital consumption allowances for tax purposes would drop below economic depreciation by only 2.6 percent. Our first conclusion is that present law provides capital consumption

allowances for corporate investment as a whole that are in line with economic depreciation at currently anticipated rates of inflation.

We next compare the two proposals for more rapid capital recovery introduced in Congress with present law. Under currently anticipated rates of inflation we find that present values of capital consumption allowances would be 27.5 percent in excess under the Senate Finance Committee proposal and 33.6 percent in excess under the Reagan Administration proposal. Under lower anticipated rates of inflation the excess of capital consumption allowances over economic depreciation would rise substantially, reaching 51.8 percent of economic depreciation under the Reagan proposal for anticipated rates of inflation of 1960. At higher anticipated rates of inflation both proposals would result in capital consumption allowances that are greater than economic depreciation.

To calculate effective tax rates under present law and the two alternative proposals, we combine information on the offset to tax liability provided by the investment tax credit with the value of capital consumption allowances as a deduction from taxable income. The effective tax rate for an asset also depends on the statutory tax rate, the rate of economic depreciation, and the rate of return after taxes, corrected for inflation. We present effective tax rates for equipment, structures, and total investment under current law and each of the two alternative proposals in Table 16. At this point it may be useful to recall that the effective tax rate for all assets under economic depreciation is equal to the statutory rate of forty-six percent, while the effective tax rate with immediate expensing of the cost of acquisition of assets is equal to

Table 16

Effective Corporate Tax Rates on New Investment

Discount Factors	Policy	Corporate Tax Rate: Equipment	Structures	Total	Ratio of Effective Rate to Statutory Rate
1960	Current	-0.22	0.20	-0.08	-0.172
	Reagan	-0.88	-0.01	-0.58	-1.267
	Senate	-0.25	0.11	-0.13	-0.277
1966	Current	-0.14	0.22	-0.02	-0.033
	Reagan	-0.71	0.02	-0.46	-1.004
	Senate	-0.19	0.13	-0.08	-0.170
1973	Current	-0.01	0.28	0.09	0.200
	Reagan	-0.52	0.07	-0.31	-0.684
	Senate	-0.10	0.19	0.00	-0.006
1980	Current	0.19	0.35	0.24	0.528
	Reagan	-0.20	0.16	-0.07	-0.161
	Senate	0.05	0.28	0.13	0.275
1980 Plus Four Percent	Current	0.29	0.39	0.32	0.702
	Reagan	-0.03	0.22	0.06	0.121
	Senate	0.14	0.32	0.20	0.440

zero. As before, we have calculated effective tax rates under alternative assumptions about anticipated future rates of inflation.

At currently anticipated rates of inflation the effective tax rate under present law for corporate investment as a whole is twenty-four percent. This is a little over half the statutory tax rate of forty-six percent. The Senate Finance Committee proposal would reduce the effective tax rate on corporate investment to thirteen percent. This would represent a little over one fourth of the statutory rate. Finally, the Reagan Administration proposal would result in a negative effective tax rate for corporate investment. The combination of very short asset lifetimes for tax purposes and an increase in the investment tax credit for some assets would imply that the corporate income tax would be replaced by a corporate income subsidy for depreciable assets. Tax deductions and credits for these assets would be available to "shelter" income from nondepreciable assets such as land, inventories, and financial claims.

If anticipated inflation rates were to increase as much as four percent relative to those that prevail currently, the Reagan Administration proposal would result in an effective tax rate of six percent. The effective tax rate under current law would rise to thirty-two percent, while the Senate proposal would result in an effective tax rate of twenty percent. If anticipated inflation rates were to drop to those prevailing in 1973, the effective tax rate under the Reagan Administration proposal would be a negative

thirty-one percent. The resulting "shelter" for income from nondepreciable assets could be sufficient to reduce receipts from the corporate income tax to zero. The negative effective tax rate under the Reagan Administration proposal would rise to forty-six percent at 1966 anticipated rates of inflation and to fifty-eight percent at 1960 anticipated rates of inflation.

Present U.S. corporate income tax law would result in an effective tax rate of nine percent at anticipated rates of inflation of 1973, a negative two percent at rates of 1966 and a negative eight percent at rates of 1960. The Senate Finance Committee proposal would result in a zero effective tax rate at anticipated rates of inflation of 1973; this would fall to negative levels at rates of 1960 and 1966, reaching a negative thirteen percent at rates of 1960. Our overall conclusion is that current law and both alternative proposals would replace the corporate income tax by a corporate income subsidy at anticipated rates of inflation comparable to those that prevailed in 1960 and 1966, while the Reagan Administration proposal would replace the corporate income tax by a corporate income subsidy at current inflation rates or at rates of 1973.

The second issue we consider in comparing alternative systems for capital recovery under the corporate income tax is the differences in effective tax rates among assets. Gaps among effective tax rates result in an inefficient allocation of capital among assets. Under present law the difference between effective tax rates on equipment and structures

at currently anticipated rates of inflation is sixteen percent. Under the Reagan Administration proposal this difference would widen to thirty-six percent. The gap for the Senate Finance Committee proposal would be twenty-three percent.

The gap between effective tax rates on equipment and structures under present U.S. law would widen to twenty-nine percent at anticipated rates of inflation of 1973, thirty-six percent at rates of 1966, and forty-two percent at rates of 1960. Under the Reagan Administration proposal the gap would widen to fifty-nine percent at anticipated rates of inflation of 1973, seventy-three percent at rates of 1966, and eighty-seven percent at rates of 1960. As before, we find it useful to translate this gap into the corresponding gap between social rates of return. For anticipated rates of inflation of 1960 the Reagan Administration proposal would result in a difference in social rates of return to investment in equipment and structures of 2.78 percent. This can be compared with the average private rate of return of 6.06 percent for the postwar period.

Our overall conclusion is that differences in effective tax rates among assets under present U.S. tax law are substantial, even at the very high anticipated rates of inflation prevailing currently. These differences increase with a decrease in anticipated rates of inflation, reducing efficiency in the allocation of capital. The differences in effective tax rates would widen significantly under the Senate Finance Committee proposal and would widen even further under the Reagan Administration proposal. Just as under present law, these gaps would increase with a decrease in anticipated rates of inflation.

We next provide additional detail on effective tax rates by type of asset under present law and the two alternative proposals. For this purpose we have calculated effective tax rates for all thirty-five assets listed in Table 1 at currently anticipated rates of inflation. We give the present value of capital consumption allowances, the effective rate of the tax credit, and the effective tax rate for each asset in Table 17. Under present law effective tax rates range from forty-eight percent for other nonfarm buildings to eight percent for aircraft. Under the Reagan Administration proposal the gap is from thirty-six percent for commercial buildings to a negative thirty-two percent for office, computing, and accounting machinery. The gap for the Senate Finance Committee proposal is from forty-one percent for other nonfarm buildings to two percent for agricultural machinery.

Similarly, we provide additional detail on effective tax rates by industry under present law and the two alternative proposals. For this purpose we have calculated effective tax rates for all forty-four industries listed in Table 13 at currently anticipated rates of inflation. We give effective tax rates on equipment, structures, and total investment for each industry in Table 18. Under present law the effective tax rates range from 35.2 percent for metal mining to 8.8 percent for air transportation. Under the Reagan Administration proposal effective tax rates would be negative for thirty-three industries and small but positive for the remaining eleven industries. Effective subsidy rates range up to 25.4 percent for trucking service, warehousing, and storage. Under

Table 17

Effective Corporate Tax Rates by Asset: Present Law

Asset	Lifetime	Present Discounted Value	Investment Tax Credit	Effective Corporate Tax Rate
1	7.8	0.743	0.09	0.12
2	9.8	0.692	0.09	0.19
3	12.2	0.639	0.09	0.24
4	5.0	0.828	0.06	0.11
5	7.8	0.743	0.09	0.11
6	7.8	0.743	0.09	0.16
7	7.5	0.750	0.09	0.14
8	10.0	0.687	0.09	0.22
9	10.0	0.687	0.09	0.21
10	7.8	0.743	0.09	0.13
11	8.9	0.718	0.09	0.28
12	8.1	0.735	0.09	0.17
13	9.7	0.694	0.09	0.21
14	4.4	0.846	0.05	0.19
15	3.0	0.897	0.03	0.16
16	6.0	0.794	0.08	0.08
17	14.1	0.601	0.09	0.27
18	11.8	0.646	0.09	0.21
19	8.3	0.731	0.09	0.17
20	8.0	0.738	0.09	0.16
21	25.3	0.389	0.00	0.45
22	41.8	0.264	0.00	0.47
23	42.1	0.262	0.00	0.45
24	42.1	0.262	0.00	0.45
25	42.1	0.262	0.00	0.47
26	27.1	0.373	0.00	0.48
27	26.3	0.380	0.09	0.32
28	23.7	0.409	0.09	0.34
29	23.7	0.409	0.09	0.33
30	21.1	0.441	0.09	0.31
31	19.3	0.468	0.09	0.33
32	21.9	0.432	0.09	0.30
33	6.0	0.765	0.06	0.14
34	24.7	0.399	0.09	0.34
35	24.8	0.398	0.00	0.38

Table 17 (continued)

Effective Corporate Tax Rates by Asset: Reagan Proposal

Asset	Lifetime	Present Discounted Value	Investment Tax Credit	Effective Corporate Tax Rate
1	5.0	0.851	0.09	-0.14
2	5.0	0.851	0.09	-0.12
3	5.0	0.851	0.09	-0.11
4	5.0	0.851	0.09	-0.19
5	5.0	0.851	0.09	-0.13
6	5.0	0.851	0.09	-0.20
7	5.0	0.851	0.09	-0.19
8	5.0	0.851	0.09	-0.15
9	5.0	0.851	0.09	-0.13
10	5.0	0.851	0.09	-0.15
11	5.0	0.851	0.09	-0.32
12	5.0	0.851	0.09	-0.19
13	5.0	0.851	0.09	-0.15
14	5.0	0.851	0.09	-0.29
15	3.0	0.913	0.06	-0.23
16	5.0	0.851	0.09	-0.21
17	5.0	0.851	0.09	-0.11
18	5.0	0.851	0.09	-0.10
19	5.0	0.851	0.09	-0.18
20	5.0	0.851	0.09	-0.18
21	10.0	0.727	0.00	0.27
22	15.0	0.529	0.00	0.36
23	10.0	0.727	0.00	0.23
24	10.0	0.727	0.00	0.23
25	10.0	0.727	0.00	0.24
26	10.0	0.727	0.00	0.29
27	10.0	0.727	0.09	0.07
28	10.0	0.727	0.09	0.09
29	10.0	0.727	0.09	0.09
30	10.0	0.727	0.09	0.09
31	10.0	0.727	0.09	0.10
32	10.0	0.727	0.09	0.08
33	5.0	0.851	0.09	-0.09
34	10.0	0.727	0.09	0.08
35	18.0	0.472	0.00	0.35

Table 17 (concluded)

Effective Corporate Tax Rates by Asset: Senate Finance Committee Proposal

Asset	Lifetime	Present Discounted Value	Investment Tax Credit	Effective Corporate Tax Rate
1	4.0	0.866	0.06	0.03
2	7.0	0.774	0.09	0.05
3	10.0	0.692	0.09	0.17
4	4.0	0.866	0.06	0.04
5	2.0	0.942	0.02	0.02
6	2.0	0.942	0.02	0.03
7	4.0	0.866	0.06	0.04
8	7.0	0.774	0.09	0.06
9	7.0	0.774	0.09	0.06
10	4.0	0.866	0.06	0.03
11	4.0	0.866	0.06	0.06
12	4.0	0.866	0.06	0.04
13	7.0	0.774	0.09	0.06
14	2.0	0.942	0.02	0.04
15	2.0	0.942	0.02	0.04
16	4.0	0.866	0.06	0.05
17	10.0	0.692	0.09	0.17
18	7.0	0.774	0.09	0.04
19	4.0	0.866	0.06	0.04
20	4.0	0.866	0.06	0.04
21	15.0	0.539	0.00	0.39
22	15.0	0.539	0.00	0.36
23	15.0	0.539	0.00	0.34
24	15.0	0.539	0.00	0.34
25	15.0	0.539	0.00	0.35
26	15.0	0.539	0.00	0.41
27	15.0	0.539	0.09	0.22
28	15.8	0.526	0.09	0.27
29	15.8	0.526	0.09	0.26
30	15.8	0.526	0.09	0.26
31	15.8	0.526	0.09	0.29
32	15.0	0.539	0.09	0.24
33	4.0	0.845	0.06	0.05
34	15.0	0.539	0.09	0.25
35	20.0	0.420	0.00	0.37

Table 18

Effective Corporate Tax Rates by Industry: Present Law

Industry	Equipment	Structures	Total
	Effective Corporate Tax Rate		
1	0.187	0.450	0.256
2	0.149	0.450	0.207
3	0.204	0.450	0.244
4	0.197	0.450	0.273
5	0.195	0.450	0.223
6	0.197	0.450	0.246
7	0.181	0.450	0.223
8	0.189	0.450	0.302
9	0.206	0.450	0.254
10	0.207	0.450	0.284
11	0.181	0.450	0.235
12	0.191	0.450	0.283
13	0.179	0.450	0.234
14	0.190	0.450	0.235
15	0.200	0.450	0.261
16	0.208	0.450	0.271
17	0.204	0.450	0.255
18	0.183	0.450	0.256
19	0.194	0.450	0.214
20	0.209	0.450	0.269
21	0.198	0.450	0.273
22	0.141	0.300	0.152
23	0.141	0.300	0.152
24	0.163	0.454	0.352
25	0.147	0.351	0.176
26	0.150	0.272	0.264
27	0.152	0.458	0.170
28	0.161	0.464	0.174
29	0.210	0.320	0.219
30	0.172	0.450	0.173
31	0.178	0.450	0.183
32	0.270	0.450	0.270
33	0.087	0.470	0.088
34	0.217	0.330	0.321
35	0.187	0.470	0.195
36	0.209	0.340	0.241
37	0.210	0.478	0.301
38	0.205	0.330	0.281
39	0.205	0.310	0.290
40	0.205	0.340	0.335
41	0.172	0.470	0.212
42	0.172	0.470	0.278
43	0.212	0.458	0.298
44	0.183	0.467	0.248

Table 18 (continued)

Effective Corporate Tax Rates by Industry: Reagan Proposal

	Effective Corporate Tax Rate		
Industry	Equipment	Structures	Total
1	-0.167	0.270	-0.051
2	-0.156	0.270	-0.074
3	-0.139	0.270	-0.072
4	-0.146	0.270	-0.021
5	-0.142	0.270	-0.096
6	-0.138	0.270	-0.059
7	-0.148	0.270	-0.083
8	-0.169	0.270	0.021
9	-0.150	0.270	-0.067
10	-0.135	0.270	-0.006
11	-0.217	0.270	-0.121
12	-0.139	0.270	0.006
13	-0.190	0.270	-0.097
14	-0.153	0.270	-0.080
15	-0.149	0.270	-0.047
16	-0.159	0.270	-0.048
17	-0.156	0.270	-0.067
18	-0.148	0.270	-0.033
19	-0.159	0.270	-0.125
20	-0.165	0.270	-0.057
21	-0.158	0.270	-0.032
22	-0.144	0.080	-0.129
23	-0.144	0.080	-0.129
24	-0.180	0.271	0.114
25	-0.190	0.100	-0.150
26	-0.180	0.067	0.052
27	-0.188	0.304	-0.158
28	-0.191	0.329	-0.169
29	-0.100	0.070	-0.086
30	0.054	0.270	0.055
31	-0.263	0.270	-0.254
32	-0.110	0.270	-0.110
33	-0.207	0.360	-0.205
34	-0.142	0.100	0.080
35	-0.256	0.360	-0.239
36	-0.152	0.090	-0.093
37	-0.150	0.298	0.002
38	-0.146	0.090	-0.003
39	-0.146	0.090	0.045
40	-0.146	0.080	0.071
41	-0.140	0.360	-0.073
42	-0.140	0.360	0.037
43	-0.168	0.333	0.007
44	-0.136	0.332	-0.030

Table 18 (concluded)

Effective Corporate Tax Rates by Industry: Senate Finance Committee Proposal

	Effective Corporate Tax Rate		
Industry	Equipment	Structures	Total
1	0.047	0.390	0.138
2	0.035	0.390	0.103
3	0.056	0.390	0.111
4	0.052	0.390	0.154
5	0.055	0.390	0.092
6	0.052	0.390	0.118
7	0.048	0.390	0.101
8	0.051	0.390	0.198
9	0.055	0.390	0.121
10	0.056	0.340	0.162
11	0.044	0.390	0.113
12	0.049	0.390	0.170
13	0.043	0.390	0.113
14	0.050	0.390	0.109
15	0.052	0.390	0.135
16	0.053	0.390	0.141
17	0.053	0.390	0.123
18	0.050	0.390	0.143
19	0.049	0.390	0.076
20	0.052	0.390	0.137
21	0.050	0.390	0.151
22	0.037	0.240	0.051
23	0.037	0.240	0.051
24	0.045	0.385	0.267
25	0.038	0.262	0.069
26	0.041	0.186	0.178
27	0.040	0.374	0.060
28	0.034	0.363	0.048
29	0.040	0.220	0.054
30	0.040	0.390	0.041
31	0.038	0.390	0.044
32	0.170	0.390	0.170
33	0.050	0.360	0.051
34	0.093	0.290	0.274
35	0.041	0.360	0.050
36	0.059	0.270	0.111
37	0.060	0.404	0.177
38	0.070	0.260	0.185
39	0.070	0.260	0.224
40	0.070	0.250	0.243
41	0.042	0.360	0.084
42	0.042	0.360	0.155
43	0.049	0.350	0.154
44	0.047	0.359	0.118

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the Senate Finance Committee proposal all effective tax rates are positive and less than 27.4 percent.

Our analysis of effective tax rates by type of asset and by industry under present law and under the two alternative proposals corroborates the conclusions we reached on the basis of effective tax rates for all U.S. corporations. At currently anticipated rates of inflation the effective tax rate under present law exceeds the statutory rate of forty-six percent only for commercial buildings, hospital buildings and other nonfarm buildings. Effective tax rates under present law are as low as eight percent for aircraft. The highest effective tax rate for any industry is 35.2 percent for metal mining. Even at very high anticipated rates of inflation prevailing currently, liberalization of tax provisions for capital recovery during the postwar period has been sufficient to keep effective tax rates well below the statutory rate for all industries. Levels of effective tax rates would decrease for all assets and all industries under both alternative proposals.

Differences in effective tax rates among assets and among industries are very substantial under current law. As before, these differences correspond to gaps between social rates of return among assets and industries. These gaps represent opportunities to increase national wealth with no sacrifice in consumption either now or in the future. These gaps would widen significantly under the Reagan Administration proposal and would narrow slightly under the Senate Finance Committee proposal.

We can emphasize the fact that effective tax rates would decrease with a decrease in anticipated rates of inflation, while differences in effective tax rates among assets and among industries would increase with a decrease in the rate of inflation.

6. Conclusions

Our first major conclusion is that inflation has had a dramatic impact on capital recovery under the U.S. corporate income tax. For a given set of tax provisions an increase in the rate of inflation reduces the present value of capital consumption allowances as an offset to the cost of acquisition of assets. The effective rate of taxation increases with an increase in the rate of inflation and decreases with a decrease in the rate of inflation. It is important to emphasize both the impact of higher inflation rates and the impact of lower inflation rates. An important objective of current economic policy is to reduce the rate of inflation. If this objective were to be realized, effective tax rates under present U.S. law would decline substantially, reaching the level of only nine percent for U.S. corporations as a whole at anticipated rates of inflation like those prevailing as recently as 1973.

Our second major conclusion is that a decrease in the rate of inflation under present U.S. law increases the gaps among effective tax rates for different assets and different industries. At currently anticipated rates of inflation these gaps are substantial, but they would widen significantly with a decrease in the rate of inflation. Differences in effective tax rates among assets correspond to differences in social rates of return to investment in these assets. By transferring investment from lightly taxed assets to more heavily taxed assets it is possible to increase the national wealth with no sacrifice in present or future

consumption. Opportunities for costless increases in the national wealth would increase considerably with a decrease in the rate of inflation.

While effective tax rates in the United States are currently among the lowest of the postwar period, proposals for further reduction in these rates are under consideration by the Congress. At currently anticipated rates of inflation the Reagan Administration proposal would result in replacing the corporate income tax by a corporate income subsidy with a negative effective tax rate for U.S. corporations as a whole. At anticipated rates of inflation like those prevailing in 1973, the Reagan Administration proposal would generate huge offsets to the cost of acquisition of depreciable assets through the investment tax credit and deductions of capital consumption allowances for tax purposes. These offsets would be sufficient to exhaust the income generated by investments in depreciable assets and would spill over to provide "shelter" for income from nondepreciable assets such as land, inventories, and financial claims.

A second consequence of the adoption of the Reagan Administration proposal for capital recovery under U.S. tax law would be a substantial widening of gaps among effective tax rates for different assets and different industries. This would very significantly worsen the efficiency of capital allocation and would reduce the level of productivity for the U.S. economy. Under current law and under both alternative proposals we have considered, the gaps among effective tax rates would increase as rates of inflation decrease. Under these policies a successful anti-inflation program would worsen the efficiency of capital allocation.

Our analysis of the impact of inflation on capital recovery under U.S. tax law also provides an answer to the obvious question arising from current pressures for more rapid capital recovery. If effective tax rates on new investment have fallen, why are investors and policy makers convinced that they have risen? The first part of the answer to this question is that effective tax rates have risen since the postwar low of 1977, when rates of inflation in asset prices had fallen to 5.6 percent in 1976 and 7.7 percent in 1977. These rates of inflation can be compared with the level of 12.8 percent in 1975 at the time of the most recent change in tax provisions for capital recovery. However, while rates of inflation were at double-digit levels in 1980, the Reagan Administration is projecting a rapid decline in rates of inflation.

A second part of the explanation for the perception that effective tax rates are currently high, while our analysis has shown that they are currently low, is the nature of offsets to tax liability. While the taxpayer receives the investment tax credit as an offset to tax liability in the year an asset is acquired, capital consumption allowances are a deduction from income and are distributed over the useful life of the asset by means of accounting formulas. In effect, the taxpayer receives a claim on future tax deductions that is analogous to a government bond. Unfortunately, the value of this claim, like the value of a government bond, drops with increases in anticipated rates of inflation. Anticipated rates of inflation have jumped almost four percent since 1975 and holders of depreciable assets, like holders of government bonds, have suffered drastic capital losses.

If the Reagan Administration's anti-inflation program is successful, both holders of government bonds and holders of claims for future tax deductions on depreciable assets will experience capital gains that will offset capital losses under the Carter Administration in the late 1970's. These capital gains will occur even with no changes in tax provisions for capital recovery. Effective tax rates will decline to very modest levels and may even become negative under current U.S. tax law. Unfortunately, this decline will be distributed very unevenly among assets and among industries. As a consequence, the efficiency of capital allocation will fall, undercutting future productivity.

The impact of the Reagan Administration tax proposals will depend critically on the success of the Administration's anti-inflation policy. If anticipated rates of inflation were to increase by four percent, the effective tax rate on new investment under the Reagan Administration proposal for capital recovery would be positive. However, substantial gaps in effective tax rates among assets and among industries would remain, resulting in a drag on productivity. If the Reagan anti-inflation program were to have no impact at all, the effective tax rate for the corporate sector would be negative, resulting in the replacement of the corporate income tax by a corporate income subsidy for investment in depreciable assets. If the Reagan anti-inflation program were to achieve its stated objective of reducing rates of inflation below those that prevailed in 1973, holders of depreciable assets would enjoy huge capital gains on capital

consumption allowances still to be claimed on their existing assets. They would also receive substantial subsidies on new investments.

Our overall conclusion is that policies for corporate income taxation that deal effectively with the impact of inflation cannot be based on accelerated capital recovery. As we have seen, variations in the rate of inflation are an important part of the problem facing policymakers. Neither the Reagan Administration proposal nor the Senate Finance Committee proposal is capable of coping with these variations. The Senate Finance Committee proposal would succeed in lowering the effective tax rates for different assets and different industries. However, the impact of this proposal, like the impact of the Reagan Administration proposal, would be strongly dependent on the rate of inflation that actually occurs.

In closing we can briefly outline two possible approaches to the reform of provisions for capital recovery under the U.S. corporate income tax that would deal effectively with the problem of inflation. First, immediate expensing of the cost of acquisition of assets would result in a zero effective tax rate on income from all depreciable assets, whatever the rate of inflation. While immediate expensing would amount to the elimination of the corporate income tax, this proposal is superior to alternative proposals that would replace the tax by a corporate income subsidy. Policy makers who are optimistic about the success of anti-inflation measures and advocate the elimination of the corporate income tax should regard present high rates of inflation as the last great opportunity to shift to immediate expensing. As rates of inflation decline,

subsidies to investment in specific assets through the tax structure will arise. Each such subsidy will generate a political constituency that will act as an obstacle to the introduction of immediate expensing.

A second pathway to the reform of capital recovery provisions of U.S. tax law is more closely related to current tax provisions and preserves flexibility in the selection of an appropriate level for the effective tax rate. The first step in tax reform would be to replace existing capital consumption allowances for tax purposes by a first year allowance, as proposed by Auerbach and Jorgenson (1980). This would completely eliminate the problems that result from forcing holders of depreciable assets to hold claims on the government in the form of future tax deductions that can appreciate or depreciate like government bonds. Since this proposal is equivalent to deducting economic depreciation, it has the unfortunate consequence of increasing the effective tax rate to the statutory rate.

The second step in tax reform would be to provide an investment tax credit that is proportional to the difference between the cost of acquisition of an asset and the first year allowance, as proposed by Brown (1981). By varying the proportion between zero and the statutory tax rate, it would be possible to produce any effective tax rate between the statutory rate and zero. Since the Brown investment tax credit, like the Auerbach-Jorgenson first year allowance, would be taken in the same year an asset is acquired, it would create no claims on the government that are subject to capital gains and losses with changes in the rate

of inflation. The resulting First Year Capital Recovery System would preserve the existing features of U.S. tax law -- capital consumption allowances as a deduction from taxable income and the investment tax credit as an offset to tax liability.

As an illustration of a system for capital recovery under U.S. tax law based on the First Year Capital Recovery System, we present in Table 19 the first year allowances for all thirty-five types of assets listed in Table 1. These first year allowances are based on a discount rate after taxes of six percent. We also present tax credits on these assets that would produce effective tax rates on all assets of zero, half the current statutory tax rate of forty-six percent, and the statutory tax rate itself. Investment tax credits would range from thirty-five percent on residential structures to seven percent on autos at an effective tax rate of zero for all assets. For an effective tax rate of twenty-three percent, which is comparable to present law at currently anticipated rates of inflation, investment tax credits would range from nineteen percent on residential structures to four percent on autos.

The First Year Capital Recovery System, as we have outlined it, would preserve the simplicity of the Auerbach-Jorgenson proposal. Existing provisions of the tax code on capital recovery could be replaced by a simple table like Table 19, giving the first year allowances and the investment tax credits permitted by law. As under immediate expensing of assets, tax deductions and tax credits would depend only on current transactions in assets and would not require a cumbersome system of vintage accounts for auditing and verification. The main advantage of the First Year System over immediate expensing is the possibility of setting effective tax rates at levels other than zero.

Table 19

First Year Capital Recovery System

Asset	First Year Allowance	Investment Tax Credit at Various Effective Tax Rates: Zero	.23	.46
1	0.645	0.16	0.08	0.00
2	0.602	0.18	0.09	0.00
3	0.565	0.20	0.10	0.00
4	0.729	0.12	0.06	0.00
5	0.616	0.18	0.09	0.00
6	0.740	0.12	0.06	0.00
7	0.731	0.12	0.06	0.00
8	0.669	0.15	0.06	0.00
9	0.630	0.17	0.09	0.00
10	0.669	0.15	0.08	0.00
11	0.818	0.08	0.04	0.00
12	0.731	0.12	0.06	0.00
13	0.660	0.16	0.08	0.00
14	0.897	0.09	0.04	0.00
15	0.946	0.07	0.04	0.00
16	0.752	0.11	0.06	0.00
17	0.553	0.21	0.10	0.00
18	0.521	0.22	0.11	0.00
19	0.712	0.13	0.07	0.00
20	0.712	0.13	0.07	0.00
21	0.373	0.29	0.14	0.00
22	0.292	0.33	0.16	0.00
23	0.237	0.35	0.18	0.00
24	0.237	0.35	0.18	0.00
25	0.273	0.33	0.17	0.00
26	0.428	0.26	0.13	0.00
27	0.225	0.36	0.18	0.00
28	0.355	0.30	0.15	0.00
29	0.331	0.31	0.15	0.00
30	0.331	0.31	0.15	0.00
31	0.426	0.26	0.13	0.00
32	0.291	0.33	0.17	0.00
33	0.452	0.24	0.12	0.00
34	0.324	0.31	0.16	0.00
35	0.173	0.35	0.19	0.00

APPENDIX

In this Appendix we describe the methodology we have used to simulate practices permitted by the Internal Revenue Service in calculating capital consumption allowances for tax purposes. Our control total is based on capital consumption allowances claimed by U.S. corporations on their income tax returns. Our depreciable base is a time series of corporate investment disaggregated by the types of assets listed in Table 1. Our objective is to estimate tax parameters by reconciling the depreciable base with reported depreciation. These parameters allow us to calculate effective tax rates in the historical period covered by our study, as well as to compare tax rates under present practices to those under proposed systems for capital recovery.

Our approach parallels an earlier study by Allan Young (1968), but contains additional detail on capital consumption practices. It should be noted that Young's study was not designed for estimating tax parameters, but for calculating capital consumtion allowances to measure profits. This does not require the level of detail we have employed. The results of our simulation of reported capital consumption allowances show that we have significantly improved and extended Young's approach.[1]

[1] Depreciation practices are known to differ significantly across industries. This is illustrated in Tables 16 and 17 of a report for the U.S. Treasury by Vasquez (1974), and also in a statistical study by Wales (1966) that estimates rates of adoption of accelerated depreciation for two digit manufacturing industries. Estimates of practices by industries, similar to our aggregate simulation, could be made with more disaggregated IRS-based data and the corresponding investment series.

We use a simulation model based on a system of closed-end vintage accounts. In each year we open a new set of accounts equal to the number of categories of depreciable investment. In general, gross investment in each asset class minus estimated salvage value serves as the depreciable base.[1] Current year investment is used for equipment investment; since capital consumption allowances on an asset are allowed only when it is put in use, structures investment, which is measured as it is put into place, is lagged one half year to approximate the lag from the enplacement of capital to the beginning of the depreciation period.[2] Each asset account is divided into two subaccounts, one for accelerated depreciation and one for straight-line depreciation.

As a particular vintage of an asset ages, annual depreciation deductions are added together until accumulated depreciation equals the base. At this point the account is terminated and no asset is depreciated below its salvage value. In a model with two depreciation methods twenty categories of investment with an average lifetime of ten years would result in approximately 400 active vintage accounts in the aggregate calculation.

[1]There are some exceptions. Salvage value is removed from the depreciable base when determining allowances with the straight-line and sum-of-the-years digits methods, but not in the case of the declining balance method, although the account still may not be reduced below its salvage value. The Long Amendment, effective in 1962 and 1963, removed the amount of the investment tax credit from the depreciable base.

[2]An extensive survey study by Thomas Mayer (1960) examined lags between the start of construction and completion and found the weighted average to be fifteen months. If capital is installed evenly during this lag, the average lag between installment and starting depreciation is seven and one-half months.

Straight-line depreciation allowances are calculated by multiplying the straight-line rate of depreciation, that is, the inverse of the assigned lifetime, by the straight-line base. For accelerated depreciation, we multiply the straight-line rate by an appropriate constant and again by the declining base. Unlike the straight-line method, the base is reduced annually by the amount of capital consumption.[1] The constant, sometimes called the declining balance rate, corresponds to the type of declining balance (i.e., 2.0 for double declining balance, 1.5 for 150 percent declining balance).

Our starting point for parameterization of depreciation is the history of tax depreciation regulations promulgated by Congress and administered by the Internal Revenue Service.[2] Depreciation entered the tax code in 1909 in order to calculate income for tax purposes. Straight-line was the accepted method for calculating depreciation, but little is known about tax lifetimes, except that taxpayers were given considerable freedom of choice. This changed abruptly in 1934 with revenue requirements of the New Deal. To achieve a desired twenty-five percent reduction in depreciation allowances, Treasury Decision 4422 was issued, shifting the burden of proving reasonableness of depreciation from the IRS to the taxpayer.

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[1] Throughout our simulation we use a half-year convention which embodies the assumption that taxpayers begin taking depreciation on their new assets at midyear. This is implemented by dividing our depreciation rates in half in the first year of an asset's life.

[2] The following history of depreciation practices summarizes relevant details found in Gravelle (1979), Pechman (1977), Young (1968), and various issues of the Statistics of Income: Corporation Income Tax Returns.

Tax lifetimes listed in the third edition of Bulletin F (1942) were generally longer than those provided in the 1931 edition and were probably indicative of the tough stance taken by the Treasury after 1934. Nevertheless, shorter lives were permitted under special facts and circumstances. In light of the long lifetimes suggested in Bulletin F, it is not surprising that controversy often arose between taxpayers and the IRS. Tax lifetimes are known to have decreased considerably below Bulletin F levels by the early 1950's, if not sooner.[1] The burden of proof of reasonableness was shifted from the taxpayer back to the IRS in 1953.

A notable exception to standard depreciation practices during the period was the special provision for 60-month amortization of defense-related facilities. Certificates of necessity for such practices were issued during World War II and years around the Korean War. This provision had its greatest effect in 1945 when a statute allowed all remaining undepreciated balances to be written off in that year. This increased depreciation allowances an estimated $1.7 billion from a total of $4.3 billion.[2]

In 1954 the more generous double declining balance and sum-of-the-years-digits methods were made available to all taxpayers for new investments. Although a small, but not negligible, amount of investment had been

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[1] See Young (1968), p. 20.

[2] Young (1968) pp. 20, 23.

depreciated with the unity-of production method before 1954 and although 150 percent declining balance had been allowed since 1946, it was not until 1954 that the widespread use of the straight-line method began to decline significantly. The decline was not rapid; even in 1961 fifty percent of all depreciation deductions were calculated by the straight-line formula.[1]

The most far reaching change in the taxation of income from capital occurred in 1962 with the introduction of the investment tax credit for equipment and certain qualifying structures. At the same time the Treasury issued Revenue Proclamation 62-21 which set forth "Guidelines" lifetimes which were 30 to 40 percent shorter on average that Bulletin F lives.[2] There is considerable evidence that lifetimes on new investment at this time were already at the level prescribed by the Guidelines.[3] The large immediate impact of the Guidelines on the level of depreciation allowances was due to the inclusion of existing as well as new assets under the system. In the long run, the Guidelines

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[1] Statistics of Income: Corporation Income Tax Returns, 1961-62, p. 6, Table E.

[2] Although it is widely believed that the new Guidelines as well as the investment tax credit applied only to equipment, there was allowance for certain structures. The Guidelines include "... special-purpose structures which are an integral part of the production process and which, under normal practices, are replaced contemporaneously, with the equipment they house ... . Special-purpose structures shall be classified with the equipment they house, support, or serve." (U.S. Treasury Dept. (1962), p. 12.) A considerable amount of investment classified as structures in NIPA falls into this category. Probably an increasing share of NIPA structures investment adopted considerably shorter tax lifetimes under this provision, as is evidenced by an increasing share of structures investment qualified for the investment tax credit, which has a similar eligibility rule.

[3] Corcoran (1979) and Vasquez (1974) reach this conclusion independently.

increased depreciation allowances through a general relaxation of all depreciation rules:

> A central objective of the new procedure is to facilitate the adoption of depreciable lives even shorter than those set forth in the Guidelines, or even shorter than those currently in use, provided only that certain standards are met and subsequent replacement practices are reasonably consistent with tax lives claimed.[1]

The "certain standards" took the form of the Reserve Ratio Test. However, after a three year grace period and subsequent extensions, the Reserve Ratio Test was never adopted. Its relative complexity would have made it difficult to administer. However, it was generally believed that the requirements of the Test would not be met by a large percentage of taxpayers, suggesting tax lifetimes lower than the Guideline lives.

In 1962 and 1963, the depreciable base of assets was reduced by the amount of the investment tax credit. The repeal of the Long Amendment in 1964 removed this requirement and made depreciation allowances even more generous. The only significant reversal in the trend toward greater acceleration of allowances since 1934 occured with the Tax Reform Act of 1969. This law limited all real estate signed into contract after July 24, 1969, to 150 percent declining balance depreciation.

In 1971, the same year the investment tax credit was re-enacted after its suspension of nearly two years, the Asset Depreciation Range (ADR) System was introduced by the Treasury. This new system allowed taxpayers to adopt lifetimes generally twenty percent above or below

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[1] U.S. Treasury Department (1962), p. 1.

their Guideline levels. Although most longer lived assets used the lower limit, some shorter lived assets moved upward within their range to take better advantage of the graduated rate of the investment tax credit.[1] Like the Guidelines, ADR was intended primarily for equipment, but had provision for special-purpose structures.[2]

The ADR was intended to simplify depreciation accounting, but actually proved quite complex, and only the largest corporations could comply with its detailed accounting requirements. However, it is believed that smaller firms, less subject to audit, have informally adopted the lower limit ADR lives.[3] The last major change in the tax code occurred in 1975 when the rate of investment tax credit was increased from four to ten percent for public utility property and from seven to ten percent for other eligible property.

A striking feature of the history of tax depreciation is the slowly evolving liberalization of actual practices in contrast to the abrupt

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[1] Since 1971, the investment tax credit has been fully effective for assets with lifetimes over six years, two-thirds effective with lifetimes of five to six, and one third effective with lifetimes of three to four. The movements within the range for shorter-lived assets are illustrated in an internal Office of Industrial Economics memo kindly provided by Dennis Cox, Deputy Director of the Office of Industrial Economics. From a nonrandom sample of approximately 2000 taxpayers in 1973, we find, for example, that ninety percent of investment in automobiles were depreciated at the ADR midpoint and therefore, become eligible for an investment tax credit. Seventy-six percent of aircraft were assigned seven year lifetimes, the upper limit of the ADR, making such investments eligible for the full tax credit.

[2] For instance, under ADR nuclear power plants were allowed to shorten their lifetimes from 20 to 16 years.

[3] This was brought to our attention by Dennis Cox.

changes in regulations. In the case of tax lifetimes, the change in practices have to some degree effectively preceded the changes in rules. On the other hand, in the case of depreciation methods, adoption of accelerated depreciation took place gradually after it was first made generally available in 1954.

The tremendous growth of corporate tax depreciation allowances from the approximate figures of $4.6 billion in 1946 to $25.3 billion in 1960 to $119.8 billion in 1978 is attributable to four factors: (1) the growth of real investment in durable goods; (2) the rising price level of these goods; (3) successive liberalizations of depreciation rules; and (4) the increasing adoption over time by taxpayers of more liberal depreciation practices. We would expect a drift towards shorter lifetimes, more accelerated methods, and lower salvage values as taxpayers became more familiar with the tax code.

In our simulation model, the growth of real investment and the rising price level for investment goods are accounted for by use of a current dollar investment series as the depreciable base. All changes in tax law mentioned above are incorporated as well. The timing of their adoption into practice, before or after change in IRS regulations as appropriate in each case, is an issue often ignored. This issue is directly addressed by calibrating simulated capital consumption allowances to actual allowances claimed by U.S. corporations.

It should be noted that data on new corporate investment would not adequately describe the depreciable base over the simulation period unless adjustment was made for the sale of used assets at prices higher than

their depreciable value. The only significant data available on used asset investment is from the Census of Manufactures. We adjust for resale of assets by constructing a used asset investment series based on percentages of used asset investment to total investment reported in the Census of Manufactures. For the years 1947, 1954, 1958, 1963, 1967, 1972 and 1977, the respective percentages are 9.6, 4.4, 5.2, 5.8, 4.3, 5.1, and 5.7. These percentages are scaled upward by a factor of 1.4 to take into account the larger proportion of used asset investment in nonmanufacturing industries apparent from Statistics of Income data on used asset investment eligible for the investment tax credit.[1] In our simulation, we create a separate set of accounts for used assets and depreciate them according to IRS rules for used assets. We assume that the undepreciated bases of original owners are thirty percent of resale value and accordingly scale down used asset investment by a factor of 0.70.

The results of our simulation are presented in Table 3 and show a close fit of simulated to actual allowances. The parameters used to calculate simulated allowances are summarized in Table 4. These results are now examined and checked for reasonableness on the basis of available information on capital consumption practices.

[1] Statistics of Income: Corporation Income Tax Returns, 1974, p. 128, Table 19, and 1975, p. 118, Table 16.

Weighted averages of assumed lifetimes of new equipment and plant used in the simulation appear in columns 2 and 3 of Table 4. All pre-1962 tax lifetimes for our 35 classes of assets are changed uniformly as percentages of Bulletin F lifetimes.[1] Before 1934, all assets are depreciated at two-thirds their Bulletin F lifetimes. In 1934, these percentages are increased to 94 percent and then decreased to 84 percent by 1944 and then to 81 percent by 1958.

According to 1962 Statistics of Income, $9.2 billion, or 30 percent of all depreciation taken was under the Guidelines. This we approximated by applying the Guidelines to 26 percent of the total depreciable basis. It is assumed that all investment depreciated under the Guidelines applied to new and existing assets. Thus, there is a sharp increase in allowances in 1962 and no corresponding change in depreciation methods or tax lifetimes for new investment.

Our methodology reconciles the conflict between the findings of Young (1968) and those of Corcoran (1979) and Vasquez (1974). In order to approximate the large jump in the depreciation allowances in 1962, Young considerably shortened tax lifetimes of new assets. However, Corcoran and Vasquez report in independent studies that no considerable decrease in lifetimes on new assets occurred in 1962. The present simulation achieves a large increase in 1962 allowances by

[1] Bulletin F and Guidelines -- ADR midpoint lifetimes are shown in Table 4.

applying the Guidelines to a fraction of all vintages, not just the latest vintage, and thus considerably increases the depreciation rate of older vintages with longer tax lifetimes.

From 1962 to 1971 it was assumed that the amount of the capital stock depreciated under the Guidelines increased in even increments each year from approximately twenty-six to one hundred percent. At the same time, lifetimes on new assets decreased by about ten percent. For 1971 and after, only Guideline-ADR midpoint lives are used to calculate depreciation. Lifetimes of certain short-lived assets were adjusted upward if they were eligible for a larger investment tax credit by doing so.

Vasquez (1974) reports a fourteen percent decrease in tax lifetimes from 1970 to 1971. In our simulation, the decrease was only about eight percent. This anomaly is probably explained by a survey sample heavily biased with ADR electors who had most to gain by the change in tax rules. Based on our estimates of Guideline ADR-midpoint lives, average lifetimes on new investment decreased sharply from 93.7 percent of their midpoint values in 1971 to 83.5 percent in 1972 to 78.5 percent by 1978.

Our results are consistent with a relatively small population of large corporations electing the ADR system quite early, followed by more gradual elections of lower ADR range lives by smaller corporations. Small corporations could less easily comply with the ADR's complex accounting requirements. In our simulation the average lifetimes of

equipment are as low as they effectively can be in the ADR range by 1978, given upward adjustments of certain assets to take full advantage of the investment tax credit.

Our average equipment lifetime in 1976 was equal to 8.43, or 82 percent of our estimate of our average Guideline ADR-midpoint lifetime. Unpublished Treasury data on the amounts of investment in each ADR class in 1976 allow us to obtain an alternative estimate.[1] The Treasury data derived estimate gives a 9.13 ADR midpoint, which translates our figure 8.43 to 92 percent of the ADR midpoint. This suggests our assumed Guideline ADR is too high, but much of this can be explained by the fact that Guideline ADR lifetimes are adjusted upward to take advantage of the investment tax credit.[2]

The amount of new investment using accelerated depreciation is reported in column 4 of Table 6. In contrast to Young's study, where all pre-1954 vintage investment was assumed to be straight-line, Statistics of Income data shows that seven percent of depreciation of pre-1954 vintage investment deducted in 1959 was calculated by accelerated depreciation methods.[3] To approximate depreciation methods before 1954, percentages of 1.5 declining balance were included that allowed us to duplicate the 1959 figure on depreciation of pre-1954 investment.

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[1] Kindly provided by William Sutton on the staff of Joint Committee on Taxation.

[2] Tax lifetimes for asset categories 4, 15, 16, and 17, which make up 19 percent of corporate investment were adjusted upward to take advantage of the investment tax credit.

[3] Statistics of Income: Corporation Income Tax Returns, 1959-1960, p. 7, Table F.

included that allowed us to duplicate the 1959 figure on depreciation of pre-1954 investment.

Following the lead of Young (1968) and Wales (1966), we take advantage of the similarity between double declining balance and sum-of-the-years digits methods and assume all accelerated depreciation after 1954 is double declining balance. In order to terminate the accelerated depreciation vintage accounts, an optimal switchover to straight-line is employed. Statistics of Income reports percentages of depreciation taken under different methods for the years 1954 to 1961.[1] This is probably our most reliable data source on which to base our parameterization. The close approximation of these figures in our simulation to the actual figures shown in the last two columns of Table 5 gives added credibility to the results. In addition, our 1971 estimate of a new investment with accelerated depreciation of 80 percent is compatible with the 81.7 percent figure reported by Vasquez.[2]

Survey results of salvage value as a percentage of original cost on buildings were reported in a Treasury study[3] and were generally found to be about one percent; accordingly, this value was used for salvage of structures in our simulation. Unfortunately, data on the salvage value of equipment are not available. However, we do make inferences about salvage values for purposes of our simulation.

[1] Statistics of Income: Corporation Income Tax Returns, 1959-1960, p. 7, Table E and 1961-62, p. 6, Table E.

[2] Vasquez (1974), p. 36, Table 16.

[3] U.S. Treasury Department (1975), Tables 23A, 23B.

Combining the two facts that the double declining balance method of depreciation is more generous than the sum-of-the-years-digits method only in the case of non-negligible salvage value[1] and that double declining balance was much more widely used historically than sum-of-the-digits, it is probable that salvage value was significant for some assets. Informal discussions with IRS field agents suggest figures on average between five and ten percent.

Although the IRS code states explicitly that no asset may be depreciated below its salvage value, certain provisions in the code do effectively lower salvage value estimated for tax purposes. For property acquired October 16, 1962, taxpayers were allowed to decrease salvage values by up to ten percent. Therefore, a salvage at fifteen percent could be lowered to five percent, and for assets with salvage values of less than ten percent, no salvage value need be considered. In 1971, ADR electors were granted an additional ten percent reduction in salvage value. Our assumed salvage values for equipment presented in column 5 of Table 6 reflect these changes in law as well as the shifts in burden of proof of reasonableness to the taxpayer in 1934 and back to the IRS in 1953.

We conclude that the simulated depreciation parameters summarized in Table 3 are close approximations of actual practices used by U.S. corporations and can replace more highly simplified assumptions often employed in models of the corporate income tax. Furthermore, by comparing these parameters with those of proposed policy alternatives, more accurate estimates of the likely impact of policy changes can be made.

[1]For elaboration, see Myers (1960).

Footnotes

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1. The rental value of capital is employed in econometric studies of corporate investment behavior by Jorgenson and Siebert (1968a, 1968b, 1972). This concept is also used in econometric studies by Jorgenson and Stephenson (1967a, 1967b, 1969) and by Hall and Jorgenson (1969, 1971). See also: Bischoff (1971) and Coen (1971). Econometric studies of investment behavior are surveyed by Jorgenson (1971) and Hall (1977).

2. A history of provisions for capital recovery is given by Pechman (1977), Gravelle (1979), and Jeremias (1979). See the Appendix for a detailed discussion of our methodology for incorporating these provisions into the rental price of capital services.

3. For detailed discussion of the geometric approximation, see Hulten and Wykoff (1980, 1981a, 1981b). References to the literature are given by Hulten and Wykoff (1981b). Additional details on the economic theory of depreciation are provided by Jorgenson (1973).

4. Efficient capital allocation under taxation is discussed by Samuelson (1964), Auerbach (1979a, 1979b), Bradford (1980, 1981) and Hall (1981).

5. Combinations of expensing and economic depreciation are analyzed by Auerbach (1979a), Harberger (1980), and Bradford (1981).

6. Estimates of economic depreciation employed in the U.S. national accounts are discussed by Young and Musgrave (1980). These estimates are employed in a study of the U.S. corporate income tax by Feldstein and Summers (1979). See Gravelle (1980c) for a detailed critique of the Feldstein-Summers study and the reply by Feldstein and Summers (1980).

7. We are indebted to Jerry Silverstein of the Bureau of Economic Analysis for preparing these estimates for this study.

8. For each industry composition of investment by type of asset for each year was determined by a biproportional matrix model described by Bacharach (1965). Elements of the initial matrix are based on interindustry transactions reported by the Bureau of Economic Analysis (1975).

9. Alternative legislative proposals have been analyzed by Feldstein (1979), Gravelle (1980a, 1980b), Leape (1980).

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SUMMARY AND STATEMENT

OF

GEORGE A. STRICHMAN
CHAIRMAN OF THE BOARD
COLT INDUSTRIES INC

ON BEHALF OF THE

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

ON
THE TAX ASPECTS OF
THE PRESIDENT'S ECONOMIC
PROGRAM

BEFORE THE

SENATE FINANCE COMMITTEE
U.S. SENATE

MAY 19, 1981

1901 L Street, NW, Suite 303, Washington, D.C. 20036 (202) 223-3293

The Committee for Effective Capital Recovery is a voluntary coalition of 549 business firms and 54 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation and utilities. A list of the member companies and supporting associations is attached (see Appendix A).
[Appendix A in official committee files]

Formerly called the Ad Hoc Committee for an Effective Investment Tax Credit, the Committee has long been active in efforts to improve, strengthen, and make permanent capital cost recovery allowances working initially on the investment tax credit.

My subject on behalf of the members of the Committee for Effective Capital Recovery is the urgent need for improved tax treatment for plant and equipment expenditures. I am here particularly to discuss the various capital cost recovery proposals which have been introduced in the 97th Congress.

Economic Justification for Improved Capital Recovery

Two of the most pressing economic problems facing this nation are declining productivity and loss of competitiveness with other nations. Both of these problems are in large part a result of our failure to revise the U.S. tax laws to take into account economic realities. Corporations are paying huge federal taxes on illusory profits--profits that result solely from the impact of inflation.

These taxes have led to reduced corporate cash flows and inadequate capital investments, which have had a slow but seriously deleterious impact on the economic health of our nation and our ability to compete with other nations.

The United States has fallen far behind its major trading partners in most key economic indicators, particularly those dealing with productivity. Other nations have recognized the importance of adequate capital recovery allowances and liberalized their tax laws accordingly; some have done so years ago and some recently. The United States has not been effective in this respect. As a result, our capital recovery provisions are far from adequate to meet our needs and it shows up in a crisis of competitiveness for world markets between the United States and other modern industrial nations.

The key to economic recovery lies in the investment of savings in plant and equipment. In 1979 capital recovery allowances accounted for approximately 88 percent of all business savings; and business savings comprised approximately 76 percent of total national savings in that year. Thus, if we wish to increase savings, we must improve capital recovery allowances.

Improved Capital Recovery Proposals

The three major proposals for improved capital recovery pending before Congress are the President's "Accelerated Cost Recovery System" (S. 683), the "Capital Cost Recovery Act" (S. 287) and the "Simplified Cost Recovery System" (S. 317). In addition, on March 17, H.R. 2525 was introduced which includes a "First-Year Capital Cost Recovery Method". The urgent need for improved capital recovery has been acknowledged by nearly every Member of Congress, by most economists and by the general public. The question this Committee and the Congress must decide is the specific method to be utilized to provide improved capital recovery.

In the past the Committee for Effective Capital Recovery has strongly supported the Capital Cost Recovery Act. In this regard we urged the Administration to adopt that Act as the centerpiece of its program for the economic revival of the United States. We are gratified that the Administration did in fact adopt, in large part, the Act as the foundation for its own Accelerated Cost Recovery System. We strongly support the enactment of the President's proposal, but urge that the proposal be modified in two respects discussed in greater detail below.

Capital Cost Recovery Act of 1981

The Capital Cost Recovery Act ("CCRA") generally would permit a 10-year writeoff for plants and buildings

(other than residential real estate), a 5-year writeoff for machinery and equipment, and a 3-year writeoff for the first $100,000 of investment in automobiles and light trucks. The period over which the cost of an asset could be recovered would begin with the earlier of the year in which such costs are paid or incurred or the year in which the asset is placed in service. In any recovery year, a taxpayer may elect to deduct all or a portion of the allowable recovery deduction. Any unused recovery deduction may be carried forward to any subsequent taxable year.

Accelerated Cost Recovery System

The Accelerated Cost Recovery System ("ACRS"), in general, incorporates the basic framework of CCRA. However, a number of differences exist between CCRA and ACRS. Some of the changes made in CCRA represent improvements while others would restrict the usefulness of the proposal. Accordingly, we urge this Committee to focus carefully on these changes and to adopt the approach which will ensure that the intended incentive is not reduced for any taxpayer.

Flexibility

The ACRS proposal departs from the CCRA proposal with respect to the flexibility allowed taxpayers in claiming depreciation deductions in the year those deductions

arise. More specifically, under CCRA in any recovery year, the entire amount of the allowable recovery deduction may be taken into account, or, at the election of the taxpayer, only a portion thereof. The amount taken into account may be increased or decreased by the taxpayer before the expiration of the time for making a claim for refund. If only a portion of the recovery deduction is taken into account, the unused amount may be carried forward and taken into account in a subsequent taxable year.

By contrast, under ACRS, depreciation must be deducted in the year in which it is allowed, and even if no depreciation deduction is claimed in such year, the basis of a depreciable asset must be reduced by the depreciation allowable. To the extent the depreciation deductions are not used in a particular year, they are taken into account as a net operating loss. Such losses may be carried back three years or carried forward 10 years.

The objective of ACRS and CCRA is to encourage capital investment in plants and equipment. Both proposals are designed to achieve this objective through the use of tax incentives, namely accelerated cost recovery. Flexibility complements this objective by allowing each business to recover its investment at the particular rate which is most advantageous. In this manner flexibility and accelerated depreciation work together to fit the needs of each particular business.

Perhaps it is easier to understand this point if we view the two concepts as components of a single system. Accelerated depreciation allows businesses to recover capital over the stated recovery period--thus a business may recover its investment as rapidly as allowed by the stated recovery periods. Flexibility allows businesses the option of recovering capital over a longer period. Denial of slower recovery where depreciation cannot be taken in a given year, due to factors which may be beyond the control of the taxpayer, prevents retention of the incentive which the proposals are intended to create. For example, the prospect that the recovery deduction may be lost due to a decline in price level for a time may have a decidedly negative impact on the decision to invest more capital in plant and equipment.

The principal arguments raised in opposition to flexibility are the administrative problems and increased complexity it creates. The administrative problems stem from the ability of taxpayers to increase or decrease the recovery deduction for a particular year at any time before the expiration of the period for making a claim for refund. The complexity arises from the need for taxpayers to maintain a new account to reflect the suspended deductions. This is a complexity that taxpayers would not find burdensome in light of the benefits it would provide.

It should be kept in mind that the proposal on the whole simplifies current law and eliminates the administrative problems created by current law with regard to the determination of an assets useful life. At the same time, it will ensure that the intended incentive is effective.

Commencement of Recovery Period

The ACRS proposal also differs from the CCRA proposal with respect to the commencement of the recovery period. Under CCRA, the cost of recovery property is, in general, to be taken into account for purposes of computing the recovery deduction at the earlier of the year payment is made or the year the property is placed in service.*/

In contrast, the general rule under ACRS provides that the recovery period commences in the taxable year in which the property is placed in service. In addition, under a special rule the recovery period commences for property with a construction period of two years or more in the year in which the taxpayer makes payment for the construction.

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*/ For self constructed assets, the cost of recovery property is to be taken into account in the earlier of the year the property is placed in service or the year the cost is properly added to capital account under the taxpayer's method of accounting.

In other words, under CCRA the recovery period for all constructed property commences when payment is made. On the other hand, under ACRS the recovery period for property with a construction period of more than two year begins when payment is made, however, where the construction period is less than two years the recovery period does not commence until the property is placed in service.

Delaying the recovery period until the property is placed in service is inconsistent with the objectives for providing accelerated capital recovery. The intent of each of the proposals is to provide for capital recovery. Viewed in this perspective it is irrelevant when the property is actually placed in service. Accordingly, recovery should commence upon payment in order to carry out the objective of the proposals.

Moreover, the placed in service concept is a carryover from the current system of depreciation based on the useful life of property. Once we abandon the outdated concept that depreciation should be allowed over the useful life of property, the placed in service concept loses its relevance and should also be abandoned.

The ACRS rule for the commencement of the recovery period is also internally inconsistent. Under that rule if construction will take two or more years recovery commences

upon payment. On the other hand, if construction takes less than two years recovery is delayed. This artificial distinction is unjustified and merely represents a carryover of current law. In addition, the reasons for commencing of the recovery period upon payment for longer term construction projects--that is to allow recovery of capital--support a uniform rule for all constructed property.

Other Differences Between CCRA and ACRS

In addition to these modifications, the ACRS proposal makes the following changes in the CCRA proposal.

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At-Risk-Rules

Under ACRS the at-risk rules of Section 465 are applied to the investment tax credit.

CCRA did not affect the at-risk rules.

Three Year Recovery Property

The $100,000 annual limitation in CCRA on autos and light trucks eligible for a 3-year write is deleted from ACRS. In addition, equipment used in research and development qualifies for the 3-year writeoff.

Structures

Under ACRS factory buildings, retail stores and warehouses used by their owners may be written off at accelerated rates over 10 years. Leased non-residential structures

and low income housing may be written off over 15 years under straight line rates. Other residential rental structures may be written off over 18 years under straight line rates.

Under CCRA all industrial and commercial structures whether or not owner-used or leased could be written off over 10 years at accelerated rates. In addition, CCRA did not apply to residential real property.

Public Utility Property

ACRS places public utility property with an ADR midpoint life of 18 years or more in the 10-year recovery category. In addition, ACRS changes the current rules with respect to the flow through of the investment tax credit.

CCRA provides a 5-year writeoff for all machinery and equipment, including public utility property. In addition, CCRA did not affect the flow through rules for the investment tax credit.

Railroad Property

ACRS applies to property which would have been depreciated under the replacement-retirement-betterment method of accounting.

Such property would have been excluded from CCRA.

Foreign Assets

Under ACRS foreign assets would be depreciated under the straight line method over extended recovery periods.

CCRA treated domestic and foreign assets alike.

Earnings and Profits

Earnings and profits would be reduced by applying straight-line depreciation to "extended recovery" periods, i.e. periods longer than the periods allowed for capital recovery.

Under CCRA straight line depreciation was used but extended recovery periods were not used in computing earnings and profits.

Minimum Tax

ACRS uses extended recovery periods for computing the tax preference items arising from accelerated depreciation of leased property.

Under CCRA extended recovery periods were not used in computing this tax preference item.

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The Committee for Effective Capital Recovery neither supports nor opposes any of these modifications. However, application of the at-risk rules to the investment tax credit is consistent with our desire to ensure that the proposal does not create any new opportunities for tax avoidance. In this regard the at-risk modification seems to be an appropriate addition to the anti-abuse provisions already part of the CCRA proposal.

Simplified Cost Recovery System

Our next point focuses on the Simplified Cost Recovery System proposal ("SCR"). The SCR proposal like the CCRA and ACRS proposals would replace the existing depreciation rules with a system which provides accelerated methods of depreciation and recovery periods which are substantially shorter than the useful lives provided under present law. However, substantial differences exist between the CCRA and ACRS on the one hand, and SCR proposals on the other. More specifically, SCR differs from the other two proposals in the recovery periods provided for machinery; the recovery methods utilized; and the treatment of gains and losses on the disposition of recovery property.

Recovery Periods

The SCR proposal, in general, retains a useful life concept for the depreciation of machinery. Under the

SCR proposal recovery periods of 2, 4, 7 and 10 years are utilized for machinery. In contrast, the other two proposals use a 3 year recovery period for autos and light trucks and a single recovery period of 5 years for all other machinery. The use of 4 recovery periods in the SCR proposal raises two significant problems. First, the use of different periods continues the present tax bias against longer-lived assets. Second, the use of different recovery periods produces a "cliff" or "notch" effect for taxpayers. For example, an asset having an ADR midpoint life of 19.5 years would be assigned a 7 year recovery period. On the other hand, an asset with an ADR midpoint life of 20 years would be assigned a recovery period of 10 years. The "cliff" effect would also exist with respect to the investment tax credit. For example, an asset with an ADR midpoint life of 8 years would be eligible for a 7.5 percent investment tax credit, while an asset with an ADR midpoint life of 7.5 years would be eligible for only a 4 percent investment tax credit. Although the effect of the reduction in the investment tax credit would to some extent be ameliorated through the shorter recovery period, the shorter recovery period would be of less benefit to small businesses in lower marginal tax brackets.

The CCRA and ACRS proposals avoid the "cliff" effect and the bias against longer-lived assets through the use of the single 5 year recovery period for most machinery.

However, in certain cases these proposals provide a longer recovery period than the SCR proposal or present law. The existence of the longer recovery is offset to an extent through the allowance of a 10 percent investment tax credit and through the 3 year recovery period for automobiles and light trucks.

Recovery Method

The SCR also utilizes a different asset grouping principle and recovery method from that used in CCRA and ACRS. The latter proposals use "vintage accounts" for depreciable personal property. Under this procedure assets acquired in the same year are placed to a single account. The recovery deduction for each year's account (*i.e.* each "vintage account") is determined by applying a statutory percentage to the capital cost in the "vintage account." The SCR proposal, on the other hand, utilizes a pooled asset account concept with respect to depreciable personal property. Under this procedure the capital cost of each asset is assigned to one of 4 open-ended recovery accounts (representing the 2, 4, 7 and 10 year recovery periods assigned to the assets). The recovery deduction would then be computed by applying one of the allowable declining balance methods of depreciation to the account balance. This procedure would not require the use of yearly ("vintage") accounts since the accounts are open-ended. However,

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because the declining balance method of depreciation must be used, the cost of an asset will not be recovered over the recovery period. For example, assume that a 4 year recovery account has an account balance of $1,000 and the taxpayer elects the 200 percent declining balance method of depreciation. During the first 4 years of use the account would produce the following recovery deductions and accounts balances.

Year 1	$1000	Account Balance
	$ 500	Recovery Deduction
Year 2	$ 500	Account Balance
	$ 250	Recovery Deduction
Year 3	$ 250	Account Balance
	$ 125	Recovery Deduction
Year 4	$ 125	Account Balance
	$ 62.50	Recovery Deduction
Year 5	$ 62.50	Account Balance

Therefore at the end of the recovery period a portion of the capital cost will remain unrecovered. This effect known as the "tailing" effect is created as a result of the fact that use of the declining balance method of depreciation is required under the Simplified Cost Recovery proposal. This problem normally could be corrected by allowing taxpayers to switch to the sum-of-the-years-digits method of depreciation in the final years of the recovery period (as provided under CCRA and ACRS). However, where "pooled asset accounts" are utilized such a change in methods of depreciation is not possible because of the fact that the cost of newly acquired recovery property is continually being added to the account.

Treatment of Gains and Losses

The use of pooled asset accounts under the SCR proposal also produces a distortion on the sale of assets. Because separate basis computations are eliminated under the pooled asset account procedure gains and losses on the disposition of assets are deferred. Thus if a loss is realized on the sale of an asset, the loss will not be recognized and will be deductible only through the normal recovery deductions allowed with respect to the asset. On the other hand, if a gain is realized on the sale of an asset the gain will reduce the balance in the account. If the gain realized reduces the balance in the account to a negative amount, that amount will be recaptured as ordinary income even though the gain would be treated as Section 1231 capital gain under present law.

In light of the above discussion, we believe that the differences in the proposals are significant and that the CCRA and ACRS proposals would do more to simply the tax law, increase savings and enhance our nation's economic health than would the SCR proposal.

First Year Capital Cost Recovery System

Our final major point concerns the First Year Capital Cost Recovery System ("FYCR"). The FYCR proposal,

in effect, constitutes a form of immediate expensing of capital investments. The amount to be deducted as expense is, however, less than the full amount of the investment. The amount to be deducted represents the discounted value of the future depreciation deductions otherwise available. The discount rate is a constant 4%. The discount period is the useful life of the asset. For purposes of useful life determination, there would be 30 different asset categories, each having a different useful life. For example, if $100 were expended to acquire an asset having a useful life of 10 years, there would be an immediate expense deduction (i.e., the "recovery deduction") equivalent to the present value of deductions aggregating $100 on a double declining balance basis over a period of 10 years, assuming a 4% discount rate.

Recovery deductions would be added to other operating losses and could be carried back 3 years. However, any "excess" recovery deductions (i.e. those which could not be carried back) would be separated from other operating losses for carryover purposes. Recovery deductions which are carried forward would be increased by the discount rate plus the increase in the implicit price deflator from the time the property was placed in service.

The proposal as a whole would do less to stimulate new investment than CCRA or ACRS and would create new complexities, as well as new controversies regarding the appropriate

discount rate, the useful life of recovering property, and its impact on net operating loss carryovers. Moreover, the proposal leaves several issues unresolved. For example, the proposal does not spell out rules for the recovery deduction where the recovery property is used property.

Investment Incentives

In recent years the cost of modern, environmentally safe plant and equipment has increased dramatically. At the same time overall business profits have not been able to keep up with these rising costs. As a result of these two factors, there has been inadequate investment in plant and equipment in recent years. This, in turn, has resulted in a slowing of the rate of productivity and economic growth.

The causes of inadequate investment in plant and equipment have been twofold. One cause is the impact of inflation and the other is inadequate capital accumulation. FYCR addresses only one element of the problem; the impact of inflation on depreciation allowances. FYCR does not, however, attempt to address the larger problem of inadequate capital accumulation. As a consequence, the FYCR proposal is less beneficial to business than any of the other three proposals.

In fact, FYCR would adversely affect such investment at a time when it is essential that new investments be made.

In this regard, FYCR would decrease investments, at least temporarily, and in the long run provide far less incentive for investment in new equipment than is provided under CCRA and ACRS. This fact is made clear in the simulations of the U.S. economy provided by Data Resources Incorporated ("DRI"). Those simulations provide the following figures for comparison.

Under the "10-5-3" proposal (including the phase-in provisions) real investment in plant and equipment would increase as follows:

	1980	1981	1982	1983	1984
Equipment	0.2*	3.2	7.4	11.7	16.3
Plant1/	0.1*	0.9	2.4	3.6	4.5

* In billions of 1972 dollars.

Under the FYCR proposal (including the phase-in provisions) real investment in plant and equipment would increase as follows:

	1981	1982	1983	1984	1985
Equipment	(0.2)*	(4.5)	(3.4)	2.1	6.00
Plant	0.1*	1.0	3.5	6.5	9.1

* In billions of 1972 dollars

1/ The estimate for real investment in plant is based on a 10 year phase-in.

It is clear from these studies that the FYCR proposal would have a negative impact on new investment in equipment during the initial years after its adoption. In addition, the overall stimulus to capital investment in plant and equipment would be greater under the CCRA and ACRS proposals.

Discount Rate

The FYCR proposal provides a single 4 percent discount rate for determining the present value of economic depreciation. In hearings before the Senate Finance Committee last July, Professor Jorgenson noted that the discount rate was equal to the real rate of return after tax for American business during the post World War II period. In other comments on the FYCR proposal it has been stated that the 4 percent discount rate reflects the real cost (after tax) of borrowing money during the same post-war period.

Neither of these theories justifies a 4 percent discount rate. In this regard if the 4 percent rate reflects the real rate of return for American business since 1945, application of that rate to all businesses is improper for several reasons. First the figure is a composite for all business, and does not reflect the real rate of return for each type of business. Moreover, the figure does reflect the differing tax rates which would be applied to corporations, and individuals. As a consequence the single discount rate

would provide too great a benefit to certain businesses with a higher actual rate of return and would provide too low a benefit to those businesses having a lower actual rate of return.

On the other hand, if the figure represents the after tax cost of money, it is too high. In this regard the post-war cost of money has been closer to two percent. In recent years the actual cost of money has been between 2 and 3 percent.

Useful Lives

In addition, FYCR would not eliminate one of the major problems with the current system of depreciation. The current system bases depreciation deductions on the useful life of property. One of the problems under present law has been the inability of the IRS and taxpayers to agree on the appropriate useful life. The IRS, on the one hand, has a tendency to assign a longer useful life to property in order to reduce the Federal revenue loss arising from depreciation deductions. Taxpayers, on the other hand, seek to assign a short useful life to property in order to accelerate capital recovery.

The FYCR proposal would retain a useful life concept as a basis for determining recovery deductions, but would modify that concept to provide a recovery allowance

based on an asset's "economic" useful life. As a consequence, many of the problems of present law would be carried over to the new system because taxpayers and the IRS would continue to disagree on the appropriate life. Moreover, new complexity would be introduced to the extent that the concept of "economic" useful life differs from the present concept of useful life.

In this regard it is unclear how useful life would be determined under FYCR. In his testimony last year Professor Jorgenson stated that economic depreciation would be determined by reference data on used asset prices. If, in fact, such a procedure were utilized the complications may be greater than under the so-called engineering approach utilized under the ADR System. For example, how would geographic differences in used asset prices be taken into account?

An additional problem under FYCR arises with respect to used property. Although Professor Jorgenson's submission is silent on the question of how recovery deductions are to be computed for used assets, his prior statements have indicated that (1) the purchaser of a used asset would receive a full cost recovery deduction (as if the asset were a new asset) but the seller would be required to "recapture" as ordinary income an amount equivalent to the recovery deduction allowed to the purchaser. The potential for complexity is obvious. Moreover, allowing the purchaser of used property a recovery

deduction premised on an economic useful life for new property unduly penalizes the purchaser of used property, who is quite likely to be a small businessman.

Net Operating Losses

The FYCR proposal would also have a serious detrimental impact on net operating losses. The specific problem arises because FYCR excess recovery deductions are excluded from the computation of net operating loss carry-overs. Instead, the deductions are carried forward as a separate item. In a succeeding taxable year income is reduced first by the carryover recovery deductions. There-after, any remaining income is reduced by the net operating loss carryover. Under this ordering system net operating losses, which in general have a 7-year carryover life, will be displaced because the carryover recovery deductions must be first used to offset income. As a consequence, the possibility that net operating loss carryovers will expire unused is enhanced. This problem will be particularly acute during the phase-in period of FYCR described below when many businesses may have net operating losses (which would be composed primarily of depreciation deductions computed under Section 167).

Phase-in

The FYCR proposal would be phased-in over a five year period beginning in 1981. During each phase-in year a

specified percentage of the cost of recovery property would be subject to FYCR and the remainder would continue to be depreciated under current law.

These phase-in rules are complex and would require extensive recordkeeping by taxpayers. In practice, two sets of records would be required to be maintained for each item of recovery property placed in service during 1981, 1982, 1983 and 1984. One set of records would include the cost basis subject to current law depreciation rules, while the other set would include the cost basis subject to FYCR. The recordkeeping requirement would be especially burdensome for small businesses because the system provides no exemption from the phase-in rules for a threshold amount of investment.

In addition, the recapture rules of FYCR provide for full recapture of deductions taken with respect to "recovery property." Under this rule, full recapture would occur with respect to tangible personal property (as under present law) and with respect to real property (subject to recapture under present law only with respect to the excess of accelerated depreciation over straight-line depreciation). As a result of the fact that real property placed in service after January 1, 1981, would be treated as recovery property under FYCR, full recapture would occur regardless of the fact that only a portion of the cost basis of such property would be recovered under FYCR. This result would appear to be unintentional but

avoidance of this problem would increase the complexity of FYCR.

Tax Credits

H.R. 2525 provides inconsistent treatment with respect to the investment tax credit and the energy tax credit. Both of these tax credits were enacted to provide tax incentives for investments in depreciable property. H.R. 2525 would deny an investment tax credit with respect to recovery property, but would continue to allow the energy tax credit with respect to such property. This inconsistency represents a major flaw in H.R. 2525 and evidences a lack of understanding of the differing purposes for the investment tax credit and for improved capital cost recovery.

In addition to denying the regular investment tax credit with respect to recovery property, H.R. 2525 would also deny the additional investment tax credit for employee stock ownership plans. This provision also seems to be inappropriate in view of the purpose for establishing the employee plan investment tax credit.

Finally, H.R. 2525 does not accurately reflect the capital recovery program outlined by Professor Jorgenson. In his most recent statements with respect to FYCR, Professor Jorgenson suggests that the first step in reforming existing depreciation rules should be to replace those rules with the

FYCR system. His second step would be to provide an investment tax credit that is proportional to the difference between the cost of acquisition of an asset and the recovery deduction under FYCR. H.R. 2525 does not, however, provide such an investment tax credit. As a result, it fails to provide the incentive effect essential to an improved capital recovery system. This departure from the FYCR proposal outlined by Professor Jorgenson makes H.R. 2525 substantially less beneficial than any other capital recovery proposal and less beneficial than present law depreciation.

Effective Date

In a press release issued on March 11, the Chairman and ranking minority member of the House Ways and Means Committee and the Senate Finance Committee announced that their intent was to support an effective date for any depreciation changes of no later than March 11, 1981. This decision is welcomed by the entire business community and reflects an appreciation of the planning difficulties affecting businessmen. However, we urge this Committee to make the depreciation changes effective January 1, 1981. Many businesses made investments between January 1, 1980 and March 11, 1981, in reliance on the effective date included in the various accelerated cost recovery proposals. As a matter of equity and fairness it would seen appropriate to make the depreciation changes effective January 1, 1981.

Conclusion

We believe the Capital Cost Recovery Act of 1981 and the President's Accelerated Cost Recovery System provide the best approach for dealing with the economic challenge facing America in the 1980's. These proposals will help fulfill our economic need for capital--for an ever expanding population, for dramatically increased energy prices, for environmental protection and for plant modernization. The proposals also constitute a major step toward the simplification of our tax laws. In both regards we believe that these proposals are superior to the Simplified Cost Recovery proposal and the First Year Capital Cost Recovery System.

For all these reasons, the Committee for Effective Capital Recovery supports the prompt enactment of the President's Accelerated Cost Recovery System. However, we urge this Committee in its consideration of the President's proposal to modify the rules with regard to flexibility and the commencement of the recovery period in a fashion which will ensure that intended incentive is not denied to any taxpayer.

DEPRECIATION NEUTRALITY

Statement by David G. Raboy
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before the
Senate Committee on Finance
Tuesday, May 19, 1981

* Organization listing for identification only. The views stated here are my own and do not necessarily represent the views of IRET .

Summary

One of the key areas of the current depreciation debate involves the question of "neutrality." A neutral system is one in which the decision to invest in one asset rather than another occurs without reference to the tax code. Under a neutral depreciation system capital would be allocated efficiently, implying that society could reach the highest level of satisfaction given scarce resources.

Two of the basic forms of capital recovery systems are economic depreciation (including those systems employing a useful life) and expensing (capital recovery systems which break the linkage with the useful life concept and whose present values approach immediate expensing). The First Year Capital Recovery system (FYCR) is an example of the former, and the Accelerated Cost Recovery System (ACRS) is an example of the latter.

My research shows that useful life or economic depreciation systems contain an inherent bias against durable assets and are non-neutral. Any time the tax rate changes under such a system, capital composition would shift. At any positive rate of tax, there would be too many short-lived assets relative to long-lived. Thus, FYCR would continue the present law bias against long-lived assets.

A system that approximates, or equals expensing will not distort the relative costs facing investors. As ACRS is a pragmatic representation of expensing, it is approximately neutral. Charges that ACRS would lead to substantially negative effective tax rates are based on faulty assumptions.

ACRS also has ease of administration to recommend it whereas, due to problems with the measurement of economic depreciation, FYCR would be an administrative nightmare. In this imperfect economic world, ACRS comes the closest to satisfying all that is desirable in a capital recovery system.

I. Overview

I am here today to testify on the concept of tax neutrality as it relates to depreciation policy. I am the Director of Research for the Institute for Research on the Economics of Taxation,[1] a non-profit research institute that was founded by Dr. Norman B. Ture, now Undersecretary of Treasury for Tax and Economic Affairs, in 1977.

The basic premise underlying this testimony is that the purpose of the tax code is to raise revenue for legitimate government activities, and not to direct forces in the economy. Thus, to the greatest extent possible, taxes should be levied that provoke the fewest disruptions to normal economic decision-making.

It is widely recognized that depreciation reform is necessary. There are two sources of disruption with respect to the recovery of capital costs. The first is that overall marginal tax rates on income from capital are so high that needed investment is not being made. Since acceleration of depreciation beyond the present law state will indeed lower the marginal tax rate on capital, changes in depreciation law would certainly address this first concern. If this were the only concern, however, the problem could be addressed by simply lowering tax rates.

The second source of disruption is the presence of a bias against durable capital assets under present law. It will not be claimed that all the woes of the steel industry can be blamed on this but it is clear that this bias has contributed to the decline of basic industry. A second remedial measure is necessary—one that creates an atmosphere where investment decisions are made without reference to the tax code. It is clear that present law depreciation treatment causes investment to be skewed in favor of less durable assets.

Thus, one of the key issues embodied in the depreciation debate is the question of neutrality. At the outset, it is necessary to decide what reasonable standards of tax neutrality are. The word neutrality implies the situation where economic decisions are made irrespective of the tax code. In the case of depreciation, the decision to invest in one type of capital instead of another ought to occur, to the greatest extent possible, as if there were no taxes at all. Implicit in the definition of neutrality is the concept that a neutral system will result in the most efficient allocation of capital. Since durability is the primary line of demarcation, the relative levels of long- and short-lived assets under such a system

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should indicate the best mix of capital; that is, we will have just the right number of basic oxygen furnaces relative to miniature golf courses. Economic efficiency, it must be remembered, is not just some abstract concept; it is clear that lack of efficiency results in lower output and productivity growth. Since it is clear that the current system is non-neutral, it should be apparent that a shift to a neutral system will cause disproportionate changes in capital composition--that is, some assets will be affected more than others. This is perfectly appropriate.

There are currently several depreciation proposals before the Congress that are claimed to be neutral--two of which will be discussed here. They are the Accelerated Cost Recovery System (ACRS), which is contained in President Reagan's economic proposal, and the First Year Capital Recovery system (FYCR) which was proposed by economists Dale Jorgenson and Alan Auerbach of Harvard University.

The FYCR proposal embodies the belief that only the actual loss of value that an asset suffers as it ages should be deductible from the tax base. This loss of value is referred to as economic depreciation and this proposal would allow a deduction, in the first year of ownership, that equals the present value of economic depreciation over the life of the asset.

In order to implement the proposal, 35 categories of assets are created. For each category, a pattern of economic depreciation is determined, based on studies by Charles R. Hulten and Frank C. Wycoff.[2] In order to determine the present value per dollar of investment, a discount rate of 6.06 percent is used based on a study by Barbara M. Fraumeni and Dale W. Jorgenson[3] which concluded that the after-tax rate of return has been stable at that rate over the post-war period. These calculations yield a table of decimals which are equal to the present values of the respective streams of economic depreciation per dollar of investment. For each asset category, an investor would determine his deduction by multiplying the amount of the investment by the relevant decimal.

Alternatively, ACRS scraps any link to the useful life concept and sets up five classes of assets. Automobiles, light trucks, and R & D capital are written off in three years and all other machinery, as well as public utility capital with a previous guideline life of under eighteen years, is written off in five. Owner

occupied non-residential structures and public utility capital with a previous guideline life of over eighteen years have a write-off period of ten years. Other non-residential structures and low income housing can be written off in fifteen years and residential rental buildings have an eighteen year recovery period.

The three, five, and ten year categories qualify for a super-accelerated write-off method involving an optimal combination of the "double declining balance" and "sum of the years digits" methods of depreciation. The fifteen and eighteen year categories must use "straight line" methods. The three year category qualifies for a six percent Investment Tax Credit (ITC) and the five year category qualifies for a ten percent ITC as does the public utility capital in the ten year category.

My research indicates that of all the depreciation systems currently being considered, ACRS comes the closest to eliminating the two disruptions mentioned above. There is no question that this system will dramatically decrease the marginal tax rate on income from capital. Further, because ACRS approximates expensing, which all parties agree is neutral, this system will eliminate the current bias against durable assets. Any system which is based on the concept of useful life or economic depreciation will lead to a continuance of the bias against long-lived capital.

The authors of FYCR contend that ACRS is non-neutral--that it would result in substantially negative effective tax rates on capital and that it would exacerbate existing tax biases in favor of certain types of assets. On the other hand, they claim that FYCR would be neutral with respect to assets of differing durabilities. The purported neutrality of FYCR, and non-neutrality of ACRS, rests on the observation that under FYCR the "effective" rates of tax, defined by Jorgenson and Auerbach as the proportionate change between before- and after-tax rates of return, will be the same for all assets. Unfortunately, this offers little grist for the analytical mill.

A more revealing inquiry involves the effects of depreciation systems on the "relative prices" of long- versus short-lived assets. The relative price analysis will be developed in this testimony.

Based on my research I offer the following conclusions:

1) To the extent that our system mimicks economic depreciation due to retention of the useful life concept, the tax code has encouraged a continual shift away from long-lived assets.

2) A system approximating expensing is necessary to guarantee neutrality.

3) Over any plausible range of inflation rates ACRS is a pragmatic approximation of expensing.

4) ACRS would result in increased investment and in efficiency gains due to the removal of the bias against long-lived assets.

5) Charges that ACRS will result in substantially negative effective rates are based on faulty assumptions.

6) FYCR contains an inherent bias against long-lived assets. Any time the statutory tax rates changed, the composition of capital would change. At any positive rate of tax, there would be too many non-durable assets relative to durable.

7) Even if the equation of tax and economic depreciation were desirable, it is impossible to measure economic depreciation at the tolerances necessary for policy purposes.

In section II, I consider the problems inherent in the measurement of economic depreciation. In section III, I develop the proper criterion for neutrality and, through numerical examples, show the non-neutrality of FYCR. In section IV, I challenge the claim that ACRS results in substantially negative effective rates and show, through examples, that ACRS approximates expensing. Appendix A contains a rigorous derivation of the relative price analysis including a proof of the non-neutrality of systems based on economic depreciation. Appendix B provides empirical evidence on after-tax rates of return. Appendix C discusses the superiority of the relative price analysis over the "effective rate" analysis.

II. Problems in the Measurement of Economic Depreciation

Even if we were to grant that the equation of economic and tax depreciation is a correct policy goal, the problems involved in measuring economic depreciation to the tolerances required for policy purposes would prove insurmountable. Again, economic depreciation is the loss of actual value that an asset suffers as it ages. Thus, economic depreciation depends on, among other things, the timing and pattern of income generation. These two concepts are under the control of the decision-making process of the firm and unless economic circumstances facing the firm never change (an unrealistic assumption) we can expect widely varying patterns of economic generation, and hence economic depreciation, for a particular asset.

Probably the most serious problem with the measurement of economic depreciation concerns the fact that the value of an asset is determined by its stream of after-tax income. A technologically efficient machine will be worth nothing to an investor if all the proceeds are taxed away, whereas in the absence of taxes it will be extremely valuable. In other words, the pattern of economic depreciation depends itself on tax treatment. Should the tax treatment of capital change, the relative and absolute patterns of economic depreciation can change decidedly. This is particularly serious because the suggested method for measurement of economic depreciation is the observation of the prices of used assets. The statutory deductions under FYCR would be based on historical data on used asset prices from a period of a given tax system. With any change in tax law, such as the implementation of FYCR, this data would be immediately obsolete.

Complicating the measurement of economic depreciation still further is the inadequacy of data in certain used asset markets. In order for such markets to properly reflect the value of used assets, they would have to be perfect--a tall order indeed. In many cases, the necessary information simply does not exist. This is one explanation why many studies employing this methodology have produced divergent results.

Considering the probability of error in measuring economic depreciation, the resultant IRS controversies would be enormous. Consider Table I which compares the allowance under FYCR with the midpoint guideline life under the Asset

Table 1
First Year Allowances Under FYCR
and ADR Lives by Asset Category

Asset	First Year Allowance	Guideline ADR Midpoint Lifetime
1	0.645	10.0
2	0.602	12.5
3	0.565	15.6
4	0.729	4.3
5	0.616	10.0
6	0.740	9.9
7	0.731	9.6
8	0.669	12.7
9	0.630	12.7
10	0.669	12.3
11	0.818	10.0
12	0.731	10.3
13	0.660	12.4
14	0.807	5.6
15	0.846	3.0
16	0.752	6.3
17	0.553	18.0
18	0.521	15.0
19	0.712	10.6
20	0.712	10.2
21	0.373	28.8
22	0.290	47.6
23	0.237	48.0
24	0.237	48.0
25	0.278	48.0
26	0.428	30.9
27	0.225	30.0
28	0.355	27.0
29	0.311	27.0
30	0.331	24.0
31	0.426	22.0
32	0.281	25.0
33	0.482	6.8
34	0.324	28.2
35	0.173	40.0

Source: "Inflation and Capital Recovery in the United States," Jorgenson and Sullivan, Discussion Paper #820, Harvard Institute of Economic Research, March 1981, pp. 75, 76.

Depreciation Range system (ADR). In many cases, categories that were treated relatively better under ADR would be treated relatively worse under FYCR. Category 33, for instance (mining, exploration, shafts and wells), has a current midpoint life of 6.8 years but would only qualify for a deduction of $ .482 per dollar of investment. Category 6 (construction machinery) on the other hand, which has a longer guideline life of 9.9 years, would qualify for a deduction of $ .74 per dollar of investment.

Given the extreme problems with the measurement of economic depreciation, the Treasury Department would be hard pressed to justify that flip-flop.

III. The Non-Neutrality of FYCR

Economic Efficiency

As was stated before, neutrality implies economic efficiency. To anyone living in an inflationary society, the concept of economic efficiency, or lack of it, is all too familiar. Underneath the immediate inflationary culprit--loose monetary policy--hide the inflationary pressures that provoke loose money. In general, an economy that continually suffers double-digit inflation is probably producing inefficiently.

In order to see how taxes in general, and depreciation policy in particular, affect economic efficiency, we must have an operational definition of efficiency. This term means different things to many people, but to an economist, an efficient system is one that, given the scarce resources of society, produces maximum output. Alternatively, such a system will produce a given level of output at minimum cost. There is no value judgement implied by this definition; rather, economic efficiency is a "positive" concept as opposed to a "normative" one involving subjectively determined social values.

Our economy is characterized by a multitude of productive processes involving many diverse resources. Under certain circumstances, these resources can be combined in a way that produces a given level of output at a minimum cost to society. Such a mix of resources is optimal--the allocation of resources is efficient. Most economists agree that the system that best allocates resources is a free market system with a high degree of competition. In the absence of distinct

market failures subject to remedial measures, government intervention tends to distort the allocation of resources and lead to inefficiencies in the productive process. As a kind of bench mark for judging efficiency, we can use a competitive market system. If we can determine what the allocation of resources would be in such a pure system, and then observe the difference when distortions are introduced, we can get a feel for the loss of efficiency involved.

Taxes, Prices, and Resource Allocation

Now that we have a working definition of economic efficiency, we can consider the effects of taxes on resource allocation. In order to do that, however, we must discuss the mechanism by which resources are allocated in general. This brings us to the role of prices in a competitive society.

Prices serve to ration scarce resources, to provide signals to producers, and as a measure of the value society places on various commodities. If producers observe that consumers are bidding up the price of a given good, it is a signal that demand for that good exceeds supply, and profits can be made by increasing production. If another good is in short supply and the price is very high, only those that place a high value on the good will purchase it.

Basic micro-economics holds that behavior is dictated by prices. If an individual consumes only apples and oranges, and apples become more expensive relative to oranges, we can expect the consumer to eat relatively more oranges and relatively less apples.

Micro-economic theory does not only indicate that prices affect resource allocation. In an extension of micro-economics which has become known as welfare economics, statements are made as to how prices affect the efficiency of the economy. In general, in a competitive economy, prices will serve to allocate resources efficiently and any external distortion of the prices that existed pre-tax leads to a loss of efficiency to society. These are not terribly controversial results, but are well accepted in public finance literature. Taxes, initially, affect prices and thus resource allocation.

Every tax has the attribute of altering relative costs. This proposition is obvious in the case of an excise tax on, say, gasoline. This tax is seen by virtually everyone as an increase in the price the buyer must pay for the fuel compared with the price he must pay for other things. This price or cost effect, however, is not limited to the levies we identify as excises. Every tax, to repeat, increases the price or cost of something or other relative to some other things; for instance, the cost of work relative to leisure, the cost of future consumption relative to present consumption, etc. Indeed, it is appropriate to think of every tax as having some "excise" effect.

A well accepted principle of public finance economics holds that the greater the excise effect, the greater the efficiency loss to society. A truly neutral tax, were it possible to design one, would not alter any of the relative prices or costs confronting any entity in the private sector; it would increase the cost of effort in the same proportion as the cost of leisure, the cost of consumption in the same proportion as the cost of savings, the cost of any one consumption good or service in the same proportion as any other, the cost of using labor services in the same proportion as the cost of capital services, and any one kind of labor or capital service in the same proportion as any other.

No perfectly neutral tax or tax system has yet been devised, nor is its attainment a realistic objective of public policy. As a practical matter, the objective of tax policy in this connection should be to reduce to the greatest extent possible the excise effects of existing taxes and to rely to the greatest feasible extent on taxes which will least alter the relative costs confronting households and businesses. The use of such taxes will approximate the desired state of an efficient allocation of resources. (See appendix C for an explanation.)

If one accepts the importance of prices, then the definition of neutrality becomes clear: neutrality exists under a depreciation system when tax rate changes do not alter the "price" of long-lived assets relative to short-lived assets. As with apples and oranges, it is possible to identify a relevant price of capital and see how relative prices are affected by different depreciation systems.

In appendix A, the derivation of the relevant price of capital is discussed and it is shown how relative prices shift when tax rates change under a system such as FYCR.

Under any system based on useful life or economic depreciation the following is true. Any tax rate increase will increase the cost (price) of long-lived assets relative to the cost of short-lived assets. As a result, capital composition will shift such that there are relatively less long-lived assets. A tax rate decrease will have the opposite effect. At any positive rate of tax, prices will be distorted from the optimum and there will be too many short-lived assets relative to long-lived assets. One should immediately question the neutrality of a system where statutory tax rate changes cause people to shift in and out of different assets. Such scampering about is inconsistent with the stated policy objective and is caused, not by changing economic conditions, but merely by tax changes.

Here I will present an analytically equivalent illustration which involves the relative values that businessmen place on different assets. An equivalent definition of neutrality would require that the relative values that businessmen place on assets not change when tax rates change. If one investment is uneconomical before a tax change, and another is not, their positions should not be reversed when a tax change occurs.

Numerical Examples

Any financial officer will tell you that revenues produced in the future are less valuable than those produced in the present. Thus, future income must be discounted to represent its "present value." In the case of capital, income should be discounted by the after-tax (private) rate of return on physical assets.

How will a businessman value an asset? Clearly, in order to justify an investment, the asset would have to return the principal plus the going rate of return. In other words, the value placed on an asset will be the present value of all after-tax income accruing to that asset.

I will provide two examples of perversities under FYCR. Under this system, relative values will be distorted.

The first shows how the values of two assets, which last different lengths of time, change in relative terms when FYCR is introduced. The second example is even more striking. It concerns the case where two assets last exactly the same

amount of time and are valued exactly the same before the introduction of a tax system with FYCR as its depreciation system. The only difference is the pattern by which each asset generates income.

Jorgenson has claimed that the after-tax rate of return on physical capital is 6.06 percent and has been stable over the post-war period. My research confirms the constancy (see appendix A for an explanation of this phenomenon and appendix B for the empirical results) and I am willing to accept 6.06 percent as an approximation. This is the discount rate employed. I will assume, initially, that there is no inflation.

Recall that economic depreciation is the actual loss of value that an asset suffers as it ages. In our simple examples, the economic depreciation per period is readily observable. The value of an asset at the beginning of any period is just the present value of all after-tax income from that point on. Similarly, the value of the asset at the end of the period is the present value of all after-tax income from the end of the period on. Thus the loss of value over the period (economic depreciation), is the difference between the present value of the income stream at the beginning of the period and that at the end of the period. In order to determine the FYCR deduction, all that is necessary is to calculate the present value of the stream of economic depreciation over the life of the asset.

Example 1

Consider two assets, both of which produce income which is fixed by technology at $100 per year. The only difference is that asset 1 lasts four years, and then destructs, and asset 2 lasts two years.

Originally these assets operate in a non-tax world and the value placed on each asset is equal to the present value of income. Table 2 shows the value of each asset.

Table 2
Value of Assets with No Tax

	Asset 1		Asset 2	
Year	Income	PV of Income	Income	PV of Income
1	$100	$94.286	$100	$94.286
2	100	88.899	100	88.899
3	100	83.820		
4	100	79.030		
Value		$346.035		$183.185

The ratio of the values of the assets is 1.889. In other words, asset 1 is 1.889 times more valuable than asset 2 to the investor.

Now suppose the government decides to implement a tax at the rate of 50 percent and include FYCR as its depreciation system. (Recall that economic depreciation is the loss of value an asset suffers as it ages. In our case, the loss of value, for any period, is just the difference in the present value of income at the beginning of the period and that at the end of the period.) Under FYCR, asset 1 would be eligible for a first year deduction of $300.645 which would equal the present value of economic depreciation. Asset 2 would be eligible for a deduction of $167.929. At a tax rate of 50 percent, the tax benefits resulting from FYCR would be $150.323 and $83.965, respectively.

Table 3 shows the value of the assets after the implementation of the tax. (Remember that the discount rate is still 6.06 percent because the after-tax rate of return has been shown to be stable. Also, the value is determined by after-tax income.)

Table 3
The Value of Assets after the Tax is Introduced

	Asset 1		Asset 2	
Year	After-Tax Income	PV of Income	After-Tax Income	PV of Income
1	$150.323 +50	$188.877	$83965 + 50	$126.311
2	50	44.449	50	44.449
3	50	41.908		
4	50	39.515		
Value		$314.749		$170.760

The ratio of values is now 1.843. In other words, the long-lived asset is relatively <u>less</u> valuable. It is only worth 1.843 times the short-lived asset after the tax implementation.[4]

Example 2

This time we will consider two assets which have exactly the same present values before the introduction of the tax system and last exactly the same amount of years. Asset 1 is the same asset as in the previous example and produces $100 per year for four years. Asset 3 also lasts four years but produces income in a pattern similar to the sum of the years digits method of depreciation. Table 4 shows the value of these two assets before the tax change.

Table 4
Value of Assets with No Tax

Year	Asset 1 Income	Asset 1 PV of Income	Asset 3 Income	Asset 3 PV of Income
	$100	$94.286	$191.519	$180.576
2	100	88.899	114.917	102.160
3	100	83.820	57.459	48.162
4	100	79.030	19.153	15.137
Value		$346.035		$346.035

Clearly an investor would be indifferent towards an investment in asset 1 and asset 3. They are of exactly equal value. Now, again, a tax is introduced at the rate of 50 percent with FYCR as the depreciation system. Table 5 compares the values of assets 1 and 3 after the tax introduction. This time asset 3 is eligible for a deduction of $313.409 for a tax benefit of 156.705.

Table 5
Value of Assets after the Tax Is Introduced

Year	Asset 1 After-Tax Income	Asset 1 PV of Income	Asset 3 After-Tax Income	Asset 3 PV of Income
1	$150.323 + 50	$188.877	$156.705 + 95.760	$238.040
2	50	44.449	57.459	51.080
3	50	41.908	28.730	24.081
4	50	39.515	9.577	7.569
Value		$314.749		$320.770

Asset 1 has decreased in value relative to asset 3 solely because of the implementation of FYCR and not because of changing economic conditions. These two examples illustrate the non-neutrality of FYCR.

The Role of Inflation

When inflation is included, the discount rate rises by the amount of expected inflation. With the higher discount factor, the changes in value will be even more severe. Thus, FYCR does not mitigate the effects of inflation--rather FYCR distortions are magnified by inflation.

IV. The Neutrality of ACRS

ACRS is a pragmatic approximation of expensing in that the present value of the deductions plus the deduction equivalent of the investment tax credits is very close to the value of immediate expensing of capital assets. Further, this treatment is the same across broad classes of assets. This will be shown in the course of answering Professor Jorgenson's charge concerning the negative effective tax rates that he claims ACRS will produce.

Professor Jorgenson contends that the Reagan Depreciation proposal will result in large-scale subsidization of depreciable assets:

> If the Reagan anti-inflation program were to have no impact at all, the effective rate for the corporate sector would be negative, resulting in the replacement of the corporate income tax by a corporate income subsidy for investment in depreciable assets. If the Reagan anti-inflation program were to achieve its stated objective of reducing rates of inflation below those that prevailed in 1973, holders of depreciable assets would enjoy huge capital gains on capital consumption allowances still to be claimed on their existing assets. They would also receive substantial subsidies on new investments.[5]

In Jorgenson's view the ACRS will result in substantially negative effective tax rates (Recall that an effective rate of tax has been defined by Jorgenson to be the percentage difference between before- and after-tax rates of return). A negative effective rate occurs if the after-tax rate of return exceeds the before-tax rate of return--that is, the total value of any credits and deductions must result in a net payout from the government to the taxpayer.

It is agreed by all involved that immediate expensing results in an effective tax rate of zero. Thus, in order for ACRS to produce a net subsidy to depreciable assets, the value of the capital recovery deductions plus the equivalent of credits must exceed the value of expensing. Since the value of expensing one dollar of investment is exactly one dollar, a negative tax rate can only occur if the deduction value of a given system, per dollar of investment, exceeds one dollar.

In order to test the validity of Jorgenson's statement, we must determine the value of the tax benefits due to ACRS. Before developing that, however, it is interesting to note the extent to which Professor Jorgenson feels that subsidies will occur. Table 6 shows Jorgenson's predictions as to effective rates assuming that inflation will continue as in the years cited.

Table 6
Jorgenson's Estimates of
Effective Corporate Tax Rates
on New Investment under ACRS[6]

Inflation Expected to Continue as in	Equipment	Structures	Total
1960	-1.17	-.08	-.79
1966	- .93	-.05	-.63
1973	- .68	.00	-.44
1980	- .29	.08	-.16
1980 + 4%	- .09	.14	-.01

These numbers are striking--in fact, so dramatic that we should be curious as to where they came from. Understanding that only when the value of a depreciation system exceeds expensing do we produce a negative tax rate, it is time to explore the value of ACRS.

The Value of ACRS

It was stated before that income had to be discounted to represent present value. This is, of course, true with depreciation deductions and ITCs. What must be compared, then, is the discounted value of ACRS in relation to immediate expensing.

Crucial to this analysis is the determination of a proper rate with which to discount the deductions and credits from ACRS. When performing economic research, it is quite common to make some simplifying assumptions about some of the variables in question. These serve to make an otherwise untenable problem manageable; but the researcher must take special care that the assumptions do not prejudice the outcome.

In his determination of effective rates, Jorgenson also had to calculate the present values of the various ACRS categories. He advanced the following logic:

> Since the deductions for capital consumption are an obligation of the U.S. Government, we have constructed discount factors for these allowances on the basis of yields on U.S. Government securities.[7]

There is no theoretical justification for such an assumption. First of all, government securities are riskless, whereas depreciation deductions carry an element of uncertainty because they can only be realized if the taxpayer has sufficient taxable income. More importantly, this assumption ignores the definition of a discount rate, which is the opportunity cost to the investor of undertaking a given project. This opportunity cost is exactly the rate of return on the next best investment opportunity. To an investor in physical capital, the opportunity cost, absent inflation, is the after-tax rate of return on a physical asset. Depreciation deductions are viewed as one component of the income stream and are discounted, if there is no inflation, at the same rate as any other income stream.

Stated differently, depreciation deductions allow the investor to keep more of the income produced by an asset than would otherwise be the case--that is, they lower the marginal tax rate on income from capital. If there were no taxes, all income would be discounted by the going rate of return. If taxes were levied, then the after-tax rate of return would be the proper rate. If depreciation deductions are subsequently allowed, the benefit, which is income produced in the same manner by the same machine, would be discounted by the same after-tax rate as all other income.

It is ludicrous to think that a manufacturer would discount depreciation deductions at one rate and other income from the same asset at another. Because depreciation deductions are eroded by inflation, however, an inflation premium is added to the after-tax rate of return. Thus, the proper discount rate should be the real after-tax rate of return on physical capital plus an inflation premium which represents the firm's expectations as to future inflation. If firms desire to maximize profits, and we assume they do, then this is the rate they will use; and in fact corporate tax departments do use such a rate.

Effective Rates

Jorgenson's assumption is not innocent; rather, it prejudices the results. The rate of return on a government security is decidedly lower than the proper rate as defined above. This increases the present value of any ACRS category and thus the chance of a negative rate.

The after-tax rate of return is said by Jorgenson to be 6.06 percent and stable over the whole post-war period. Empirical research conducted by this author confirms that the after-tax rate of return has been constant over the post-war period and has been within the range estimated by Jorgenson. Thus, for illustrative purposes, we will accept this figure. In Table 7 we compare a representative rate with respect to the Jorgenson assumption with what we feel is the proper rate--6.06 percent plus an inflation component as represented by the percentage change in the GNP implicit price deflator. It should be noted that implicit in the inflation component is the belief that inflation will continue at that rate indefinitely. Also, the GNP deflator has tended to be at the low end of inflation indicators in recent times.[8]

Table 7
A Comparison of Discount Rates

Inflation Component Assuming Inflation as in	1 Year Gov. Security	IRET After-Tax Return+ Inflation Component
1960	3.55%	8.3%
1966	5.12	9.9
1973	7.24	12.4
1980	11.61	15.06
1980 + 4%	15.61	19.06

To show the mischief that is caused by using an improper discount rate, we start by comparing the present values of the ACRS five year category under the two discount assumptions. Table 8 gives these results.

Table 8
Comparison of Present Values Per Dollar of Investment
ACRS Equipment Category[9]

Inflation Component Assuming Inflation as in	Jorgenson	IRET	Immediate Expensing
1960	$1.1586	$1.0903	$1.0
1966	1.1247	1.0696	1.0
1973	1.0457	1.0392	1.0
1980	1.0485	1.0093	1.0
1980 + 4%	1.0033	.9632	1.0

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Table 8 yields some interesting results. First, the present values of the five year category are quite a bit higher under the Jorgenson assumption. Further, at almost any rate of inflation, using the proper discount rate produces a present value only slightly higher than immediate expensing. Considering our assumptions (see notes 8 and 9), even these are probably higher than would occur in reality. Thus it is fair to say that over a plausible range of inflation rates, the five-year category approximates expensing.

Consider the case where inflation is anticipated to continue at the 1973 rate. Under our discount assumption, the inflation rate is only 6.34 percent. Yet, the value of the five year category exceeds expensing by less than 4 percent. It is curious to imagine how such treatment could produce a negative 68 percent tax rate!

Even more curious is an investigation of the ten, fifteen, and eighteen year categories. With the proper discount rate, assuming inflation continues as in 1973, the present value per dollar of investment for the ten year category (for the portion not eligible for a ten percent ITC) is $ .6949. Even with the Jorgenson assumption the value is $ .7971, decidedly less than expensing. How can there possibly be a zero tax rate for structures? Remember that some assets in the ten year category qualify for a credit. Table 9 compares the value of this category under the Jorgenson and IRET assumptions.

Table 9
Present Values Per Dollar of Investment
Ten Year Category with 10% ITC

Inflation Component Assuming Inflation as in	Jorgenson	IRET
1960	$1.1064	$ .9891
1966	1.0642	.9558
1973	1.0127	.9088
1980	.9230	.8646
1980 + 4%	.8561	.8076

Using the correct discount it is impossible to produce a present value that exceeds expensing under any of the above inflation rates. Table 10 looks at the fifteen year category.

Table 10
Present Values Per Dollar of Investment
Fifteen Year Category

Inflation Component Assuming Inflation as in	Jorgenson	IRET
1960	$.7888	$ .6008
1966	.7171	.5539
1973	.6358	.4924
1980	.5105	.4395
1980 + 4%	.4298	.3777

Of course, the present values of the eighteen year category are even lower. Thus, under any inflation rate, no matter what proportion of structures qualify for a credit, the value of the structures category will always be considerably less than expensing. It is impossible, then, to produce a zero effective rate of tax.

Given the above information, one must seriously question Jorgenson's method of calculation. Considering the complimentary relationship between structures and equipment, it is entirely possible that the total effective rate of tax will be positive, but it will never be negative as Jorgenson insists.

To repeat, over any plausible range of inflation rates, the value of ACRS will approach expensing. We live in a world full of uncertainty and risk that is subject to severe political pressures. In a purely theoretical world, neutrality would be the only criterion for judging a depreciation system. In the real world, other factors become extremely important. It has been illustrated here that ACRS, in a pragmatic sense, satisfies the neutrality criterion, whereas FYCR would fail even in a theoretical world. Further, ACRS has such things as ease of administration to recommend it.

FYCR, on the other hand, would be an administrative mightmare. The controversies and difficulties involved in the estimation of economic depreciation would exacerbate the existing complexity of the tax code. Given the political realities of the world, ACRS comes closest to fulfilling all that is desirable in a depreciation system.

Footnotes

1. The organization listing is for identification only. I am testifying on my own behalf. The views presented here are my own and do not necessarily represent the views of IRET.

2. See, for instance, Charles R. Hulten and Frank C. Wycoff, "Economic Depreciation and the Taxation of Structures in the U.S. Manufacturing Industries: Empirical Analysis," The Measurement of Capital, University of Chicago Press, 1980, pp. 83-109.

3. Barbara M. Fraumeni and Dale W. Jorgenson, Capital Efficiency and Growth, Ballinger, Cambridge, pp. 9-250.

4. The difference is small simply because, in the example, the numbers used were small. In reality the change in value could be sizable indeed.

5. Dale W. Jorgenson and Martin A. Sullivan, "Inflation and Capital Recovery in the United States," Discussion Paper #820, Harvard Institute of Economic Research, March 1981, pp. 75, 76.

6. Ibid., p. 57.

7. Ibid., p. 23.

8. Actually, the proper inflation factor should be a percentage change in a capital goods price index. The 1980 rate was 11.5 percent as opposed to a rate of change in the GNP deflator of 9 percent. Thus, the discount rate should be even higher.

9. The following assumptions were employed: it is assumed that firms make quarterly tax payments. Employing the equivalent of a half year convention, it is assumed that the firm purchases an asset in mid-quarter. Thus, the discount period for the first deduction is only .125, 1.125 for the second deduction, etc. If anything, this inflates the present values because it assumes firms have perfect foresight as to their future tax liabilities. In reality, first period deductions should probably be discounted by a larger factor.

A 46 percent tax rate is assumed, thus the deduction equivalent of a 10 percent ITC is 21.7 cents per dollar of investment.

Individuals anticipate that inflation will continue as in the year cited.

Appendix A
The Effects of Economic Depreciation on Relative Prices

In this appendix I will consider what happens to the price of long-lived relative to short-lived assets under a system where economic and tax depreciation are equated.

Assume a perfectly competitive neo-classical world. Clearly, no such world exists. It will be shown, however, that the results of this paper hold and actually become magnified when market distortions are introduced.

This neoclassical world is characterized by unlimited exit and entry and contains economic actors blessed with perfect foresight. It is understood that the goal of firms is to maximize their profits. Microeconomic theory has shown that a firm's profits are at a maximum where the value of the marginal contribution of a given factor just equals the price paid to that factor--in the case of capital, the implicit rental price. When the value of the marginal product of capital just equals the implicit rental price of capital, the first order conditions of profit maximization are satisfied, and the firm is in equilibrium.

When this rental price differs from the value of the marginal product, firms will desire more or less capital services and the aggregate stock of capital will change through the process of investment or disinvestment until equilibrium is reestablished. Investment (disinvestment) serves to restore equilibrium because it is understood that a firm's production function exhibits decreasing marginal productivities for the various factors. For example, if the rental price is less than the value of the marginal product of capital, then the firm will undertake net investment. As investment flows lead to increases in the stock of capital, the marginal product of capital will decrease until the equilibrium condition is met.

The expression for the implicit rental price of capital, developed by Dale Jorgenson and associates, [10] involves the following logic. At equilibrium, a firm will be willing to pay for a capital asset a price that just equals the present value of the after tax income stream that the asset will produce over its life, where this present value includes positive and negative tax items, a pattern of capacity decay, and a relevant rate of discount. Given the last three items and the selling price of the asset, one can solve for the implicit rental price which can be thought of alternatively as the per period payment one would observe in a market where firms rent capital, or the marginal contribution necessary to purchase an asset when prices are given.[2]

The aspects of neo-classical theory that are important to my analysis can be restated here. A firm employing many factors will make decisions such that the values of the marginal products for each factor are equal to the input prices. We will be interested in how changes in tax rates under the depreciation system defined above will affect the relevant discount

rate and thus the relative factor input prices for capital types of different longevities. To the extent that relative prices change, investment flows will favor one type or another, leading to changes in capital stock composition.

The Discount Rate

A discount rate represents the real opportunity cost, to the firm, of investing in a given project. As any project may be expected to yield income over some time horizon, the relevant rate is an expected rate and further it is an after tax rate.[19] In our neoclassical world, where the future is known with certainty, the expected and actual rates are one and the same. It should be noted that as the internal rate of return is the rate which equates the cost of an asset with the present value of the income stream, in a competitive world the after tax internal rate of return and the relevant discount rate are equal.

The early literature on neo-classical investment theory assumed that the before tax rate of return was constant over time, leading to an after tax discount rate that varied directly with the tax rate. To certain authors,[19] this concept was a simplifying assumption for theoretical work. Others, pointing out that discount rates were, in part, a function of tax incidence, justified a discount rate that varied directly with the tax rate by arguing that the short run incidence of taxes on capital income was borne by the owners of capital.[10] The theoretical justification for this was that price-taking firms could not shift taxes forward in output price.

More recently, empirical evidence has shown that the after tax discount rate has remained constant over a long time span in which many different tax changes occurred (see appendix B). Of course,

in the real world market imperfections contribute to such a phenomenon. Market power, enabling some firms to shift taxes forward in price, and uncertainty, leading to higher discount rates in a risk filled environment, all contribute to the constancy of the discount rate. It is the purpose of this section to review the reasons why a discount rate that does not vary directly with the tax rate is perfectly compatible with a neo-classical world. It will be shown that in the long run, taxes can be "shifted" by mechanisms other than price decisions. Original work in this area was done by Harberger [9] and Feldstein [7].

The key ingredients of this argument are the aggregate inter-temporal consumption choice and the properties of diminishing marginal productivity and factor substitutability in the production function. In the long run, investment and savings decisions are analytically equivalent. Any positive increase in the tax rate on income from capital increases the cost of future consumption, relative to present consumption. Thus, a tax rate increase will lead to a decrease in the demand for capital services and eventually a contraction in capital stock. This decrease in capital stock implies an increase in the marginal product of capital and an increase in the related before tax rate of return. But the after tax rate of discount will not drop by the full amount of the tax as will be seen below.

For illustrative purposes a simple "corn" model will be employed. In this one sector world there is only one good which is both a capital and a consumption good and therefore the price of output and capital can be normalized to unity. For simplicity it can be assumed that the capital asset suffers no loss of capacity over its life. Thus, the marginal product of capital equals the before tax rate of return.[3] Production

occurs via a linearly homogeneous production function which has the following properties.

$$\frac{\partial F}{\partial K} > 0 \qquad \frac{\partial^2 F}{\partial K^2} < 0 \qquad (1)$$

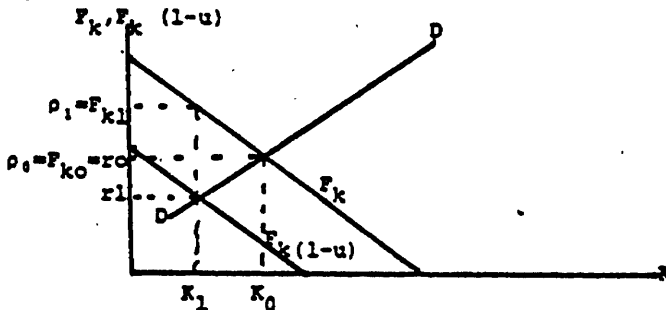
where F(K,L) is a production function with K being the capital input.

Because of the overall inter-temporal consumption choice, we know that the demand for capital is an increasing function of the after tax rate of return. If u is the rate of tax and ρ the before tax rate of return, then ρ must adjust as follows:

$$\frac{d\rho}{du} = \frac{dF_k}{dK} \cdot \frac{dK}{du} \qquad (2)$$

ρ can remain constant only if the right hand side is zero, that is if the marginal product of capital is completely inelastic with respect to capital or the demand for capital services is perfectly inelastic with respect to after tax rate of return.

Graphically this can be depicted as follows:



In the graph, capital stock is measured on the horizontal axis while the marginal product of capital (F_k), the before tax rate of return (ρ), and the after tax discount rate (r) are measured on the vertical axis. In period (o) there is no tax. Firms will discount by $r_o=F_{ko}=\rho_o$. In period (1) a tax at rate u is imposed. Demand for capital services drops to K_1. The before tax rate of return has risen to F_{k1} but the after

tax discount rate has fallen to only r_1. The tax rate, u, is the vertical distance between the before and after tax marginal product curves. Clearly, the discount rate has not dropped by the full amount of the tax.

Under plausible conditions, the discount rate could be expected to lie anywhere within the limiting cases of a constant after tax rate of discount or a rate that varied directly with tax changes. Just where is an empirical question, and as was indicated earlier, the evidence implies that the discount rate approaches the former. If a firm were to discount by the latter rate, even though some other rate occurs in reality, that firm would be overestimating the value of the investment by underestimating the real opportunity cost of the investment.

The purpose of the above exposition was to show the theoretical basis for a discount rate that does not vary directly with the tax rate in a neo-classical world. Add to this world market imperfections (e.g. certain firms exercise market power and uncertainty exists) and a constant after tax discount rate is not at all implausible. The ramifications of this phenomenon on capital stock composition will become very apparent in the next section.

Tax Changes and the Composition of Capital

Having succeded in avoiding mathematical notation for most of this paper, the honeymoon is over. It is necessary at this point to state the implicit rental price formula as it exists in the literature. This expression is derived by solving for the initial income component in a present value formula. The implicit rental price, c, is defined as follows.

$$c = \frac{q(r+\delta)(1-k-uZ)}{1-u} \qquad (3)$$

where

q = the selling price of the asset

r = the relevant rate of discount

δ = the rate of capacity decay with $0<\delta<1$. δ is an asymptotically decreasing function of the physical life of the asset. As the life gets larger, δ approaches 0. It is assumed that capacity decays in a geometric manner[4]

u = the statutory tax rate

k = the rate of investment tax credit

Z = the present value of tax depreciation deductions on one dollar of investment

To illustrate the effects of tax changes under the above mentioned system we will expand the world described in the last section to include two capital types K_1, and K_2, and to allow for capacity decay. K_1 is the longer lived asset implying that $\delta_1 < \delta_2$.

Our tax system allows the deduction of economic depreciation. Starting at an initial equilibrium at a statutory tax rate u, the before and after tax internal rates of return can be solved for, and it can be shown that the effective rate of tax for all firms of both capital types is, in fact, u. Also the after tax rate of discount is $r=\rho(1-u)$ where ρ is the before tax rate of return, the same for both assets.

Jorgenson and Hall [10] have shown that, for any capital type, the present value of economic depreciation on one dollar of capital is

$$Z^* = \frac{\delta}{(1-u)\rho + \delta} \qquad (4)$$

Since economic depreciation is deductible, that is $k + uZ = uZ^*$, (4) can be substituted into (3) which has been shown to yield the following expression for any capital type.

$$c = \frac{q(\rho(1-u)+\delta)(1 - u\delta/(\rho(1-u)+\delta))}{1-u} \qquad (5)$$

$$= q(\rho + \delta)$$

Now assume that the powers that be decide to increase the tax rate by an amount Δu. Instanteneously, the effective rate for all firms is $u + \Delta u$. Here the interemporal consumption choice comes into play and because of the positive tax increase the aggregate stock of capital will contract.

In light of the analysis in the last section we know that ρ, the before tax rate of return, is an increasing function of the tax rate; that is:

$$\rho = \rho(u) \ , \quad \frac{\partial \rho}{\partial u} > 0 \qquad (6)$$

An increase of Δu will cause an increase in ρ to, say, ρ'. Notice that the effective tax rate on all existing capital at the new level is still $u + \Delta u$. All firms have the same before tax rate of return, ρ', and discount by $\rho'(1-u)$ at the new equilibrium.

However, a major change has occurred in the composition of the capital stock. Given the new discount rate, the value of economic depreciation is

$$z' = \int_0^\infty \delta e^{-[\rho'(1-u) + \delta]t} dt = \frac{\delta}{\rho'(1-u)+\delta} \qquad (7)$$

For any capital type, the rental expression is

$$c = q(\rho'+\delta) \qquad (8)$$

A comparison of the ratios of rental prices for both capital types before and after the tax change will show the direction of the change in capital stock. Clearly the following is true:

$$\frac{c_1}{c_2} = \frac{q_1 \ (\rho + \delta_1)}{q_2 \ (\rho + \delta_2)} < \frac{q_1 \ (\rho' + \delta_1)}{q_2 \ (\rho' + \delta_2)} = \frac{c_1'}{c_2'} \qquad (9)$$

The numerators contain the rental prices for K_1, the denominators, the rental prices for K_2. The rental price of the long lived asset has risen relative to the short lived asset. With the initial level and composition

of capital, firms would not be maximizing profits because the ratio of the values of the marginal products for the respective capital types is less than the ratio of new rental prices. That is

$$\frac{MVP_1}{MVP_2} < \frac{c_1'}{c_2'} \tag{10}$$

Equilibrium can only be restored when (10) holds as an equality. At the new equilibrium, the stock of K_1 has contracted relatively more than K_2.[5]

This section illustrates the fact that any tax rate change will change the relative prices of capital types with different longevities. A tax increase will decrease the stock of long lived assets relative to short lived assets. A tax decrease will have the opposite effect.

FOOTNOTES
Appendix A

[1] The internal rate of return is the discount rate that equates the lump sum cost of an asset to the present value of the income stream that the asset produces over its life. The simple algebra mentioned here can be performed as follows. Given a present value formula with no taxes, solve for the internal rate of return. Now, consider the same formula with tax terms included. Solve this formula for the internal rate of return. Given the before and after tax rates of return, the effective rate can be determined. In the case of the depreciation system defined above, all terms except the statutory tax rate will drop out of the expression.

[2] For a derivation of the implicit rental price, see Jorgenson [10].

[3] To see this consider a rental expression in a non-tax world. At equilibrium the value of the marginal product equals the rent. But since all prices are normalized to unity and there is no depreciation term, the marginal product equals the before tax rate of return.

[4] The assumption of geometric decay makes the mathematics tenable. There is empirical evidence (Hulten and Wycoff) that capital does decay in a geometric manner.

[5] I have assumed that the production function is homogeneous. This means that firms expansion paths are linear. Under this condition a change in relative prices necessarily implies a change in relative amounts. Since MVP_1 has to increase relatively more than MVP_2, K_1 has to decrease relatively more than K_2.

Appendix B

An Empirical Test of the Relevant Rate of Discount

The test employed here is based on the following logic. Since the expected after tax rate of return is the relevant rate of discount it is possible to make inferences by fitting different discount rates to actual investment data and observing the best fitting alternative. If, as we assume, firms are rational, then such a test will tell us something about the relationship of before tax rates of return, taxes and after tax discount rates.

The model employed is the neo-classical investment function as originally formulated by Jorgenson and associates with contributions from others. This function was fitted to annual time series data for total manufacturing equipment from 1947 through 1976 employing different specifications of the discount rate.

The Model

Production occurs via a Cobb-Douglas production function and the goal of firms is profit maximization. Given the expression for a first order condition of profit maximization with respect to capital, Jorgenson and Hall have shown that the expression for a desired stock of capital is [10]

$$K^* = \alpha \, (PQ/c) \qquad (11)$$

where

K^* = the desired stock of capital

α = the elasticity of output with respect to capital

P = the price of output

Q = the quantity of output

c = the implicit rental price of capital.

As in the literature it is posited that net investment in a given period is a function of changes in present and past levels of desired stocks. Denoting net investment in period "t" as I_t:

$$I_t = \sum_{i=0}^{\infty} \omega_i \Delta K^*_{t-i} \qquad (12)$$

where the first two ω_i are estimated freely and the rest are assumed to decay at a geometric rate λ where $0<\lambda<1$. Thus our equation becomes

$$I_t = \beta_0 \Delta K^*_t + \beta_1 \Delta K^*_{t-1} + \beta_1 \lambda \Delta K^*_{t-2} + \beta_1 \lambda^2 \Delta K^*_{t-3} + \cdots + \varepsilon_t \qquad (13)$$

Applying a Koyck transformation to (13) yields

$$I_t = \beta_0 \Delta K^*_t + (\beta_1 - \lambda\beta_0)\Delta K^*_{t-1} + \lambda I_{t-1} + (\varepsilon_t - \lambda\varepsilon_{t-1}) \qquad (14)$$

If we denote $\frac{1}{\alpha}\Delta K^*$ as X_t, the regression equation is:

$$I_t = B_0 X_t + B_1 X_{t-1} + \lambda I_{t-1} + V_t \qquad (15)$$

where[6]

$$B_0 = \alpha\beta_0$$

$$B_1 = \alpha(\beta_1 - \lambda\beta_0)$$

$$V_t = \varepsilon_t - \lambda\varepsilon_{t-1}$$

The Implicit Rental Price

Following Tideman [14] we explicitly include price expectations in our rental formula. The intuition is that firms expect the real quasi-rent to remain intact, in the presence of inflation while statutory depreciation deductions are eroded and must be discounted at

a nominal rate. Incorporating this our actual rental formula is:

$$c = \frac{q(r-\pi+\delta)\ (1-k-uZ + umZK)}{1-u} \qquad (16)$$

where

- q is given by an equipment goods deflator published by the Bureau of Labor Statistics
- δ is set at .1471.[7]
- k is the rate of investment tax credit
- u is the top marginal corporate tax rate
- Z is the present value of depreciation deductions employing a nominal discount. We employ a weighted average of accelerated and straight line methods.[8]
- m indicates the years in which the investment tax credit had to be deducted from the depreciation base. It takes on a value of unity in 1962 and 1963, 0 otherwise.
- r is the relevant rate of discount. Specification is discussed below.
- π is the rate of inflation

Discount Specification

Many tests were run, one of which is reported here. Interested readers can contact the author for other tests, all of which produced similar results.

In this test a representative rate was chosen and modified to either be constant or vary with the tax rate. The rate, a Aaa bond rate, was chosen arbitrarily and when deflated by a price index, was relatively constant over time. There is no implied theoretical link between this rate and the actual before tax rate of return on physical capital. An observed rate was used to account for business cycle activity.

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This rate was modified for sensitivity testing. Points were added (as well as other methods of increasing the rate) to give a spread of absolute rates. Points added ranged from 3 to 30, giving quite a variety of rates. Each rate was then multiplied by (1-u), (1-u/2), and unity to represent direct variance, semi-variance, and no variance with respect to the tax rate. Thus, three variants of discount rates were tested.

Estimation

The problems with estimating an auto-regressive scheme such as (15) have received a great deal of attention in the literature. The two major problems with estimating this equation are the inclusion of a possible stochastic right hand variable and the possibility of serial correlation even if the original (from the untransformed equation) residuals are uncorrelated.

To estimate (15) we adopted the technique originally suggested by Liviatan [11] and shown to provide consistent estimates by Schmidt [12]. This is the technique of instrumental variables employing present and lagged exogenous variables as instruments.[9]

In this case X_t, X_{t-1}, and X_{t-2} are used as instruments. Consider the matrix of instruments $Z = [X_t, X_{t-1}, X_{t-2}]$ and the matrix of observations $X = [X_t, X_{t-1}, I_{t-1}]$.

Our instrumental variable estimator of the coefficient vector B is $b_I = (X'Z(Z'Z)^{-1}Z'X)^{-1}X'Z(Z'Z)^{-1}Z'I$

Evaluation

As was stated above each variant of the discount rate was included in a separate regression. The rate specification, in each test, which

best fit the data was chosen as the most representative of firms' expectations.

Our goodness of fit statistic was the standard error of the regression. However, certain criteria had to be met before the standard error was inspected.

- Plausible coefficients. All coefficients had to have the right sign and be significant. B_1, however could be negative or even zero. Under the Koyck rationalization, for instance, $B_1 = \alpha(\beta_1 - \lambda\beta_0)$ Depending on the relative magnitudes of β_1, λ and β_0, B_1 could take on any sign. Due to the formulation of the lag, λ is required to be positive and less than one.

- Auto-correlation must not exist. The Durbin-Watson "d" was observed, though somewhat suspiciously. "d's" of approximately 2.0 were required. Residual plots were crucial in checking the validity of this statistic.[10]

If the above mentioned criterion were fulfilled, then the equation with the lowest standard error was chosen.

It should be noted that there is probably no way to test the statistical difference between the standard errors of two equations. As Coen [6] has pointed out, the conventional F test fails in that the residuals of any two equations would be highly correlated. This violates the assumption of independence between the two variable being considered.

Results

In this test we provided a wide spectrum of values for before tax rates of return. What differentiated the three cases was the relative variance in discount rates due to tax changes.

Tables 1 through 3 give the relevant coefficients and statistics for the cases of constant after tax discounts, discounts that vary partially with the tax rate, and discounts that vary directly with the

Table 1 - Constant Discount Variant

Coefficients and Statistics

Aaa Rate Plus..	β_0 (S.E.)	β_1 (S.E.)	λ (S.E.)	Stand Error of Regression	d
.04	.0083 (.0027)	.0034 (.0042)	.9796 (.1658)	1384.85	1.6919
.05	.0092 (.0029)	.0040 (.0044)	.9644 (.1584)	1375.72	1.704
.06	.0100 (.0031)	.0046 (.0046)	.9527 (.1517)	1370.91	1.7313
.07	.0107 (.0033)	.0052 (.0047)	.9433 (.1467)	1368.71	1.7635
.08	.0114 (.0035)	.0057 (.0049)	.9359 (.1427)	1367.81	1.7978
.09	.0122 (.0038)	.0062 (.0051)	.9294 (.1398)	1368.24	1.8316
.1	.0129 (.0040)	.0067 (.0053)	.9238 (.1376)	1369.14	1.8649
.11	.0136 (.0042)	.0072 (.0055)	.9191 (.1358)	1370.37	1.8973
.12	.0143 (.0044)	.0077 (.0057)	.9146 (.1346)	1372.26	1.9285
.13	.0150 (.0047)	.0081 (.0059)	.9109 (.1336)	1373.63	1.9591
.14	.0157 (.0049)	.0085 (.0061)	.9073 (.1331)	1375.64	1.9888
.15	.0165 (.0051)	.0089 (.0064)	.9036 (.1329)	1378.41	2.0170
.16	.0172 (.0054)	.0094 (.0066)	.9003 (.1328)	1380.95	2.0448

Table 2

Semi-Varied Discount with Respect to Tax Rate

Coefficients and Statistics

Aaa Rate Plus..	β_0 (S.E.)	β_1 (S.E.)	λ (S.E.)	Standard Error of Regression	d
.04	.0063 (.0025)	.0022 (.0035)	.9811 (.1450)	1451.88	1.7524
.05	.0070 (.0027)	.0025 (.0037)	.9721 (.1422)	1437.83	1.7486
.06	.0077 (.0028)	.0029 (.0039)	.9639 (.1392)	1426.84	1.7504
.07	.0083 (.0030)	.0033 (.0041)	.9568 (.1364)	1418.34	1.7569
.08	.0090 (.0031)	.0037 (.0043)	.9505 (.1338)	1411.78	1.7667
.09	.0097 (.0033)	.0040 (.0045)	.9451 (.1314)	1406.71	1.7790
.1	.0102 (.0034)	.0044 (.0047)	.9405 (.1290)	1402.63	1.7935
.11	.0109 (.0036)	.0047 (.0049)	.9363 (.1273)	1399.58	1.8079
.12	.0115 (.0037)	.0051 (.0051)	.9326 (.1257)	1397.21	1.8230
.13	.0121 (.0039)	.0054 (.0053)	.9293 (.1244)	1395.38	1.8385
.14	.0127 (.0041)	.0057 (.0054)	.9263 (.1232)	1393.97	1.8542
.15	.0132 (.0042)	.0061 (.0056)	.9236 (.1222)	1392.92	1.8700
.16	.0138 (.0044)	.0064 (.0058)	.9212 (.1213)	1391.97	1.8864

Table 3 - Directly Varied Discount
With Respect to Tax Rate

Coefficients and Statistics

Aaa Rate Plus..	β_0 (S.E.)	β_1 (S.E.)	λ (S.E.)	Standard Error of Regression	d
.04	.0040 (.0021)	.0013 (.0026)	.9657 (.1282)	1530.2	1.8511
.05	.0045 (.0022)	.0015 (.0028)	.9627 (.1269)	1520.28	1.8489
.06	.0049 (.0023)	.0016 (.0029)	.9600 (.1255)	1511.08	1.8473
.07	.0054 (.0025)	.0018 (.0031)	.9574 (.1242)	1502.6	1.8464
.08	.0058 (.0026)	.0019 (.0033)	.9550 (.1230)	1494.82	1.8460
.09	.0063 (.0027)	.0021 (.0034)	.9528 (.1219)	1487.69	1.8462
.1	.0067 (.0028)	.0023 (.0036)	.9508 (.1208)	1481.17	1.8469
.11	.0072 (.0029)	.0024 (.0038)	.9489 (.1197)	1475.22	1.8480
.12	.0076 (.0030)	.0026 (.0039)	.9472 (.1187)	1469.79	1.8496
.13	.0081 (.0031)	.0027 (.0041)	.9457 (.1177)	1464.83	1.8515
.14	.0085 (.0033)	.0029 (.0042)	.9442 (.1168)	1460.31	1.8537
.15	.0089 (.0034)	.0030 (.0044)	.9429 (.1160)	1456.17	1.8563
.16	.0094 (.0035)	.0032 (.0045)	.9417 (.1152)	1452.39	1.8591

tax rate for a wide range of the tested rates. Having observed residual plots, and given the problems with the "d" statistic in auto-regressive situations, it was deemed that all equations were acceptable from a serial correlation standpoint.

The interesting result was that every equation employing a constant discount performed better than any equation employing a semi-varied discount. In turn, every semi-varied discount equation performed better than any equation specified with a directly varying discount. These observations were true for an enormous spread of plausible before tax rates leading to the conclusion that the relative variance with respect to tax rate is quite important indeed. Although no statistical test was available to test the statistical difference between standard errors, observed differences were considerable and are believed to be significant.

Footnotes

Appendix B

[6] There are many rationalizations for an auto-regressive scheme such as (15) including adoptive expectations, stock adjustment and the Koyck lag. Since we have no a priori information as to which variant is proper, the definitions of the coefficients should not be taken too seriously.

[7] This comes from the estimate that the rate of decay is equal to two times the inverse of the life of the asset. This number was used by Jorgenson. Coen has questioned this assumption and has attempted to estimate patterns of capacity decay for industries at the two-digit SIC level. In other tests (not discussed here) we employed Coen's results, but concluded that since Coen made an arbitrary assumption as to discount rates, the estimation of capacity decay patterns became a case of one equation and two unknowns. Since Hulten and Wycoff have confirmed the geometric pattern, as a best guess we retain Jorgenson's result.

[8] Sum of the years digits was used as a proxy for accelerated methods. The weights were based on separate work by Norman B. Ture and Thomas Vasquez.

[9] The consistency of estimates is only evident in large samples. Certain authors have expressed concern that instrumental variable estimators will be biased for small samples and that a maximum likelihood method is preferable.

Not being blessed with a readily available M-L routine we opted for the instrumental approach. Several other estimation techniques were tried but the stated method yielded the best results. We feel that the biases are minimal and do not effect our qualitative conclusions.

An explicit correction for auto-correlation was also employed in our technique.

[10] In the case of auto-regressive schemes, the "d" is usually biased. Although the instrumental approach should have removed much of the bias, residual plots were used as a check.

Appendix C

The Proper Neutrality Criterion

A lively debate has existed in the economic literature as to the proper criterion by which to judge neutrality. On the one hand is the "effective rate" criterion which is used by Jorgenson and Auerbach. The other criterion, which I feel is proper, is the "relative price" criterion.

The effective rate criterion takes the following form: an effective rate is defined as the proportional change between before- and after-tax rates of return. Under this criterion neutrality is defined as the situation where effective rates are the same for all assets. Since, in a competitive economy, after-tax rates of return would be equalized across all assets, this would require that before-tax rates of return be equal also. The proponents of this criterion believe that this equalization indicates efficiency because national income could not be increased by re-allocating capital. The point that is being missed here is that equalization of before-tax returns (which merely refers to income--not total output including the replacement of the capital stock) does not imply equalization of the marginal outputs of each capital type--which is the relevant concept.

A basic rule of efficiency, well documented in the economic literature, is that the values of the marginal products of all capital be equal. Under a system where economic and tax depreciation are equated, at any positive rate of tax this would not occur. The before-tax rates of return would be equal but not the values of the marginal products. Thus, given scarce resources, output could be increased by simply re-allocating resources to longer lived capital.

In a perfectly competitive world, absent market failures and taxes, prices will allocate resources efficiently. This is because people are free to trade until their satisfaction is maximized. For instance, in a two good world, individuals will exchange the two goods until each indvidual achieves the perfect mix. At this point each individual's satisfaction is at a maximum, given the relative scarcity of the two goods. At this point an equilibrium is established and a ratio of exchange, that is, a set of relative prices, is fixed. Given any other external conditions this

ratio of exchange is an optimum because if it were not, further trade would occur until the maximum was reached and the ratio of exchange would change. Changing economic conditions might change this ratio, in which case a new set of relative prices would be optimal. To the extent that external forces distort any optimal set of relative prices, however, society is forced away from the most desirable position.

At a non-distorted optimum, the individual's subjective marginal rate of substitution between the two goods is equal to the price ratio. If, for instance, taxes distort the price ratio, then individuals are forced away from the marginal rate of substitution that was shown to have maximized satisfaction.

An analogous situation occurs with production. Given any two factors of production, output is maximized where the marginal rate of technical substitution equals the ratio of factor prices. Any tax-induced distortion of the factor price ratio forces producers to employ factors inefficiently--that is the marginal rate of technical substitution will differ from the optimum.

Economists have written extensively about economic efficiency and have derived a set of "Pareto optimality" conditions, named after the economist Vilfredo Pareto. Pareto conditions are "positive" conditions as opposed to normative--that is, they do not include subjectively determined social goals such as income redistribution or the proper division of output between investment or consumption. Pareto conditions merely state the necessary efficiency provision so that no one person can be made any better off, without another person being made worse off.

In order to achieve a Pareto optimum production must be efficient. Thus, a necessary condition is that the marginal output contribution from each factor be equal. Obviously if this were not true, resources could be re-allocated (to the factors with the higher marginal product) such that output could be increased. A basic condition for efficiency in production is that the values of the marginal products of all factors be equal.

In appendix A it was shown that a profit maximizing firm will employ a factor up to the point where the value of the marginal product just equals the factor input price. It was also shown that the relevant factor input price is the implicit rental price of capital.

In a purely competitive world, absent taxes, factors would be employed until rental prices were equalized. Rates of return would also be equal but since assets last different amounts of time, selling prices would differ.

If a tax were introduced with economic depreciation deductible, the rental prices would change in relative terms as was shown in appendix A. At the new equilibrium the values of the marginal products would not all be equal and thus the economy would be operating inefficiently even though before-tax rates of return would be equalized.

A similar line of reasoning was used by Boadway (1978) to reject the effective rate of tax criterion for neutrality. The "optimal taxation" literature has successfully documented the desirability of not distorting relative prices (see Sandmo 1978).

It might be argued that markets are distorted to the point where the competitive model is no longer appropriate--that is, we live in a "second best" world. It has been shown by Diamond and Mirlees (1971) that even in a second best world, it is usually desirable to maintain efficiency in production. Thus, the relative price test is legitimate from a pragmatic standpoint.

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Senator LONG. Well, it sounds to me like we have made some headway. Thank you very much.

The CHAIRMAN. Our next panel consists of David Silver and Alfred Cohn, from the Investment Company Institute, John T. Fey, chairman of the board, Equitable Life Assurance Society of the United States, on behalf of the American Council of Life Insurance, Joe Morris, president of Columbia Savings on behalf of United States Savings Association and Ralph S. Saul, chairman and chief executive officer, INA Corp.

Unless there is objection, you may wish to proceed in the order your names were called and your entire written statement will be made a part of the record.

Mr. Silver.

STATEMENT OF MR. DAVID SILVER, PRESIDENT OF INVESTMENT COMPANY INSTITUTE

Mr. SILVER. Thank you, Mr. Chairman. My name is David Silver and I am president of the Investment Company Institute. I am accompanied by Edwin Cohen, our tax counsel, who I think needs no introduction to this committee.

We appreciate the opportunity to appear before you today. The Institute is the National Association of a Mutual Fund Industry. Out of 571 member mutual funds have assets of some $160 billion and approximately 12 million shareholders.

The President's program calls for a first group of important tax revisions with other desirable changes in the tax laws being deferred to a second bill.

However, press reports in recent days indicate that there may be some flexibility in this regard. Moreover, one question has surfaced with increasing frequency, and that is the possibility of an inflationary result flowing from a tax cut in the absence of some specific encouragement to individuals to save.

Aside from any possible dangers of inflationary pressures being generated by a tax reduction, there is an affirmative need to directly encourage savings by individual taxpayers.

Personal savings of United States citizens as a percentage of disposable income, fell in 1979 to a level of 4.5 percent, the lowest in some 20 years. Our savings rate is lower than that of other major countries, including Canada, West Germany, France, and Japan.

Moreover, from 1970 through 1978 our productivity growth was less than that of any of our 7 major trading partners except Great Britain.

We have studied the tax related savings plans in these countries, but the primary purpose and the primary reason for our support of S. 243 is based on our domestic needs.

S. 243 would modify the Federal tax laws to encourage individual savings, primarily for retirement, but also to help families meet educational and housing needs. It does this by building on existing programs rather than creating new complicated tax structures.

These objectives are important and urgent. Housing starts are at the lowest levels in years, educational costs continue to escalate and any reasonable program which encourages Americans to help save for their own retirement is both useful and desirable.

S. 243 accomplishes its results by pinpointing retirement, housing and education as part of an integrated program of individual tax relief.

First, the bill makes permanent the exclusion from tax of the first $200-$400 on a joint return—of dividend and interest income and increases that amount to $500 or $1,000 on a joint return for persons over the age of 65.

Second, it would remove the present prohibitions against use of IRA's by persons who are participants in a qualified employee plan. It would universalize IRA's.

Third, it would increase the limit on deductible contributions.

Fourth, it would permit modest nondeductible contributions to IRS.

Fifth, it would permit withdrawals from IRA's without the present 10 percent penalty tax: First for the purchase of a first home, and second to pay for higher education or vocational training of a taxpayer's children.

We believe that these recommended changes in IRA's would permit these plans to play a major and efficient role in capital formation.

Michael J. Boskin, Professor of Economics at Stanford University has studied the economic impact of S. 243. His study indicates that if enacted S. 243 will result in an annual savings gain of nearly $20 billion or more over the next few years.

In summary, we believe that S. 243 combines in a single package the benefit of many proposals that have been advanced and that have achieved support.

We think that it could be a major contribution to the economy of the Nation. It would not be inflationary because funds placed in IRA's are invested to help fill the Nation's needs for capital formation and improved productivity.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Fey.

OPENING REMARKS OF JOHN T. FEY, CHAIRMAN OF THE BOARD, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. FEY. Mr. Chairman, gentlemen. My name is John T. Fey, I am chairman of the board of the Equitable Life Assurance Society and I represent the American Council of Life Insurance which consists of 520 life insurance companies with roughly over 100 million policyholders and assets of more than $475 billion.

Our annual investments are in excess of $75 billion.

We are not appearing here today to speak in behalf of specific legislation, but rather to give our enthusiastic endorsement to a 3-year commitment to reduce the marginal rate by 10 percent a year, and to liberalize depreciation allowances.

We are enthusiastically behind the administration's program and its economic policy dealing with inflation. We have, as an industry, been concerned for many years with the rise in the burden of Government spending and recurring deficits.

We have been concerned because of its impact upon our money markets, the competition of the Government as a borrower with

the private sector, and the inability of the Federal Reserve to effectively manage the money supply in such an environment.

We also have been concerned with the impact of inflation combined with our tax structure in raising the effective marginal rate on taxpayers, so that in a period of 10 years the effective marginal rate on the average wage earner moved from 22 percent to almost 32 percent.

The effect of the increase in the effective rates of taxation has been to discourage work and savings and investment.

Our endorsement of the 3-year program of reduction of marginal rates is dependent upon the entire economic program that has been advanced by the administration and is conditioned upon the continuation to make every effort to reduce Government spending and to reduce Government deficits to gradually reduce the growth of our money supply and to encourage in every way, private investment and the improvement of productivity.

It is our feeling that the public perception is equally important in fighting this great problem of inflation. The public and the financial markets must believe that the President and the Congress as well as the Federal Reserve are committed to a long-term program, not just in 1981, but in 1982 and 1983 and thereafter.

Business acts on what it sees ahead for 3 or 5 or 10 years, and it will not take the risk if the future is filled with uncertainty. Lenders will not make long term or fixed investments when they do not know what the interest rate situation nor the inflation situation is going to be.

Money goes where it is treated best. Now, I said we were not speaking in favor of any specific legislation, but there is one bill that I feel the committee should be aware of that we are very enthusiastically behind that would be considered in the second tax bill. Is is a combination of Senator Dole's bill, S. 12, and the bill introduced by Senators Mitchell and Durenberger, S. 1049.

These bills deal with the deductibility of employee contributions, voluntary or mandatory, to qualified employee retirement savings plans. We feel that legislation of this nature would effectively reduce pressures on social security. It would be a noninflationary tax cut, it would assist in capital formation, it would encourage the formation of new plans and stabilize old plans and that in all equity, it should be equal to the IRA limitation.

We feel that the limitation should be increased from $1,500 to $5,000.

In conclusion, I would say that we are not necessarily making an appeal for a specific piece of legislation on our own behalf, but that our appeal is for a meaningful program to reduce Federal spending to restore growth, to restore equality and equity in our tax structure and to reduce inflation.

Thank you very much.

The CHAIRMAN. Mr. Morris.

OPENING REMARKS OF JOE C. MORRIS ON BEHALF OF U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. MORRIS. Thank you, Mr. Chairman. My name is Joe Morris, I am president of Columbia Savings Association of Emporia, Kans.,

and appear today on behalf of the U.S. League of Savings Association.

We appreciate this opportunity to testify on various proposals which would encourage thrift and help rebuild the capital so desperately needed to restore the health of the housing industry and noninflationary economic growth.

Because of the limited time for oral comment, I would like to direct your attention to the last three pages of my prepared testimony beginning at the bottom of page 6.

We wish to submit a new variation to the saver's incentives theme. A proposal which adds new dimensions to the tax break for savers' objective shared by many of the bills sponsored by members of this committee.

Unlike the other tax incentives for saver plans, our plan would not only reward depositors, but it could immediately lower the cost of credit to borrowers and it would help restore the vitality of our hard-pressed institutions.

In recognition of the newer term concerns about budget deficits, and revenue impact, our All Savers' Tax Act is carefully limited in amount and duration.

Our proposal is to exclude interest earned to $1,000 for individual taxpayers and $2,000 on a joint return on savings committed to a special 1-year account opened during the period from July 1 of this year to June 30, 1982. The tax exempt account would be available at all kinds of depository institutions. Bank's savings bank, credit unions and savings and loans.

A new special account is available for public visibility. It would be more marketable than the current $200 exclusion which customers only appreciate when they file their income tax returns.

In recognition of the tax exempt feature, rates would be limited to 70 percent of an index base on 1-year Treasury bills and adjusted periodically though the after tax yield would remain attractive to the saver.

Importantly, this would provide lower cost funds to the institutions, so they in turn could charge affordable rates to borrowers. For mortgage lenders like ourselves, our new mortgage borrowers could look for rates like 13 percent rather than the 16 to 17 percent that we must charge today.

Because of the interplay between the $1,000 and $2,000 exclusion limit, and in the index grade, we anticipate that this account would be of greatest appeal to middle income taxpayers.

Those in the tax brackets between 30 percent and 45 percent.

We estimate that as much as $180 billion in savings would be attracted to this account at all types of regulated institutions. At our savings and loans we expect a significant flow into such an account.

Not, incidentally, such a plan could enable our institutions to contribute tax revenues to the Treasury this year rather than claim loss carrybacks and refunds.

There will be other significant supply side benefits and they will come before any static revenue impact, since the effect would be spread over tax years 1981, 1982, and 1983.

Our proposal would provide stability to our financial system. It would give us a competitive tool to meet the challenge from the

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money market mutual funds without escalating our operating costs. It could remove the much publicized possibility of special Federal assistance to the ailing thrift industry.

The 1-year term on the account provides true capital formation, not the temporary parking or pot money which turns in investment uses of questionable long term benefit to our economy.

We ask your careful consideration of this all savers tax, when you confront the difficult task of developing a noninflationary tax reduction package this year.

On behalf of the U.S. League I welcome this opportunity to present our views and look forward to your questions.

Thank you.

The CHAIRMAN. I might say in response to the all savers plan you suggest, we are having a Joint Tax Committee take a look at it to see how impact on revenues and hope that information is available later on in the week.

Mr. Saul, I think Senator Heinz hoped to be able to be back to hear you but you may proceed.

OPENING REMARKS OF RALPH S. SAUL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF THE INA CORP.

Mr. SAUL. Thank you, Mr. Chairman, members of the committee, I am Ralph S. Saul, chairman of INA Corp., a diversified financial services organization.

We support the President's economic recovery program. Not only do we endorse linking tax reductions to additional spending cuts, but we congratulate the administration for its commitment to these principles and the Congress for responding favorably to the President's initiatives.

As both have recognized, restoring our economic vitality depends upon continuing to reduce Federal spending. No long term success can be achieved without halting the uncontrollable drain of government entitlement programs, including social security.

In the search for alternatives, we favor solutions that foster private industry participation in meeting public needs that would otherwise be met through Government funding.

Today, we wish to bring to your attention a proposal which, in our view, would achieve that objective. Given the many and often difficult choices facing the committee, we hope you will be interested in the concept that would provide tax relief, stimulate individual savings, promote capital formation, and strengthen social security through a new individually based retirement option.

Our proposal, which we call the Social Security Option Account, or "SSOA", would allow individuals paying social security taxes to choose an alternative means for providing for their retirement. They would continue to pay social security taxes, but, in effect, would trade future benefits for a present income tax reduction.

The concept, simple in design, works as follows:

Employees who pay social security taxes may establish a special retirement account, then deduct their annual contributions from their taxable income.

Tax deductions, limited to 20 percent of social security wages, would be paid into a tax-free account, administered by a qualified

private fiduciary. The individual may draw on the account when he or she retires.

Employees setting up SSOA's would forfeit a portion, say, a half percent, of their social security retirement benefits for each $1,000 contributed to an SSOA. When individuals compare the amount of benefits given up, to permissible tax deductions, our plan becomes an attractive alternative for a broad range of employees.

To determine the effect of our plan on social security retirement planning and capital formation, independent experts and INA evaluated how various factors such as the rate of forfeiture, the worker's age, tax bracket, wage level and expected return on investment would influence individuals to select an SSOA. We also examined the economic effects of the SSOA plan on reduced social security outlays and general revenue losses.

Based on this initial analysis, we concluded:

The SSOA plan, properly structured, would be attractive to a broad range of workers of all ages at various income levels without an unreasonable loss to the Treasury and with substantial benefits to the Social Security system.

Specifically, preliminary estimates indicate that in ten years, the program would produce a capital pool of between $40 and $100 billion (in 1981 dollars); about one-third would be new capital.

Estimates also show that by the year 2005, the SSOA program would reduce payments annually by 10 to 25 billion in 1981 dollars. A one-half percent forfeiture rate would cost between $1 and $2.5 billion annually in general revenues, offset in part by increased revenues stimulated by new investment.

INA has prepared a detailed study on our proposal which will be available to committee members and staff.

While proposals before this committee address just one issue such as tax relief, savings incentives or social security solvency, our proposal attempts to deal with all three.

By encouraging individual savings and retirement planning through tax incentives, SSOA will yield substantial capital formation benefits. Moreover, it provides a bonus for the social security system by easing the demand on future benefits while maintaining needed revenue levels.

We recognize that our plan is simply a proposal, and we defer to the committee and the administration on the appropriate timing and legislative vehicle for its consideration. However, we hope you will find it sufficiently attractive to initiate your own evaluations of the SSOA's long-term consequences and its overall public benefits and costs. I very much appreciate the opportunity to appear before this committee.

Thank you.

The CHAIRMAN. Thank you, Mr. Saul. I am advised by staff that they are starting an analysis of the proposal.

Senator Long.

Senator LONG. Thank you, Mr. Chairman. No questions.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Yes; I want to know from those of you who have suggested incentives to encourage savings as per tax credit and no income tax on interest income, how do you answer the critics who say that we have already done hasn't really encouraged

savings, but has only given an exemption from income tax to other people, to people who have already saved and hasn't really brought about any new savings.

Mr. MORRIS. One of the answers that I would give is as yet the tax, the effect to the individual tax payer is not felt. He has not filed his tax return and won't until April of 1982. So, it's really hard to judge the effect of that at this time.

Senator GRASSLEY. So, your maintaining that they have no basis for the conjecture that it hasn't encouraged savings.

Mr. FEY. Well, I think the growth of the private pension funds, the IRA's, the Keogh plans, have all indicated that the incentive does work.

Senator GRASSLEY. OK, I am only suggesting in regard to the $200 exemption from income tax for interest income for the years 1981 and 1982.

Mr. FEY. I think that is so small that it doesn't have any real impact.

Mr. SAUL. I agree it is minimal.

Senator GRASSLEY. Your saying if it was increased to a $1,000 it will dramatically encourage savings.

Mr. FEY. It would increase them in geometrical style, it wouldn't just go off arithmetically.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. I think we have had testimony earlier this week that, in fact I think the Joint Tax Committee may have advised some of us for pushing this first approach of $200 to $400 that it wouldn't have much of an impact as far as savings are concerned. If we did it anyway, I'm not certain what an analysis would show is an appropriate time.

It has been suggested by Dr. Feldstein that maybe we ought to make it a percentage. That would, in other words, exclude the first 20 percent or 10 percent up to a certain amount that might have more of an impact. I think he indicated the other day that the $200 to $400 had practically zero impact.

But, I think we have had a couple of new novel suggestions presented. I think Mr. Morris made the point that no one knows about this until tax time. Perhaps there is a more effective approach. I'm not suggesting that yours isn't the answer, maybe it is. But, at least you could market that and I assume the same with SSOA.

SSOA looks like a big, big IRA. It might cost a pretty big bundle the way it is now described. We do intend to analyze it. Do you have any cost estimates yourself.

Mr. SAUL. We do, Mr. Chairman. In fact, our analysis does show the loss to the Treasury and then contrast that with the savings to the social security funds. The analysis would indicate that for every dollar of revenue loss there is a $2.50 saving to the social security trust fund.

If I might, Mr. Chairman, just respond to one other point and that is what we are proposing is really a three-pronged approach. First, there is the need to deal with social security and we are presenting a proposal that we think may help strengthen the social security system.

The second is the strengthening of the private employment based pension system. I think John Fey to my right has a proposal there which would permit employees to make tax deductions for contributions to private pension plans and then the third area is strengthening individual participation in their own income retirement security programs.

Our proposal attempts to achieve these latter goals in connection with relief to the Social Security system. So, just to generalize, SSOA it is a three-pronged problem involving social security, strengthening private pensions and also building up the incentives for individuals to provide for themselves.

Senator GRASSLEY. Do you fear suggestion on retirement as a direct tie in with social security or just something that in the public's mind is a supplement.

Mr. SAUL. No; I think this is a direct tie-in with social security.

In other words, the point of this is to strengthen the social security system and at the same time, encourage people to provide for their own retirement planning.

Senator GRASSLEY. In other words, reinforce the concept of social security is just a foundation for building your own retirement.

Mr. SAUL. Exactly, and more as a safety net, and not as a national retirement program.

Senator GRASSLEY. Has that been successfully tried in other countries that you know of.

Mr. SAUL. I don't know, Senator whether it has.

Senator GRASSLEY. You don't know of any precedent then.

Mr. SAUL. What has troubled us is seeing the social security system over time turned into what is, in effect, a national retirement system, which I don't think was the original purpose of the system.

Senator GRASSLEY. I have no further questions.

The CHAIRMAN. Would this health fund take care of our funding problems with social security?

Mr. SAUL. It would help.

Senator LONG. If you gentlemen would pardon me for asking a question—I want to ask Mr. Cohen, because he recalls so well what I am getting ready to discuss. Mr. Cohen you were in the room when we were having a conference on the Revenue Act of 1969 and you are familiar with what I said about the debate about everybody getting a percentage tax cut, across-the-board and the justice of it and the running debate between the Washington Post and Mr. Grace.

Basically, I tended to beg the question from my point of view because it would assume that we had a fair tax system to begin with, so the across-the-board cut would assume that the system was fair to begin with.

You were the representative of President Nixon who sat in the room when we had that long conference in 1969, and you had started out with a bill that would cut back on the corporate rate as well as the individual vote and it reflected quite a bit of the philosophy of the bill we have before us today.

The House took out everything that benefited corporations and on the Senate floor, Mr. Gore was able to take out every thing that

benefited anybody except one who might be having some benefit of the increase of the standard deduction and personal exemption.

In that conference you told me that you thought that this had been converted into a soak-the-rich bill, that at least it could be accused of that by people. That prompted me to agree to help get an amendment added so that we will at least limit earned income to 50 percent. So, we did that the following morning after we had agreed the night before to support the bill.

I would just like to know if you agree with me that we ought to try to eliminate that discrimination against investment income.

Mr. COHEN. Yes, Senator Long. I think it is our objective on the House side and throughout the 1969 legislation to try to get a rate reduction at the same time that we are plugging loopholes in the Tax Reform Act of 1969.

There has been objection made to closing the loopholes and reducing taxes on the grounds that if we plug the loopholes and reduce the rates the following year that Congress would raise the rates back up again.

And, the irony of the situation was when we came to the conference that we plugged loopholes and the rate reduction that had been in the beginning of the bill that had been eliminated not in the next Congress but in that very same bill. And, so I remember exhausted as we all were, at 3:30 in the morning I asked leave to speak and I asked that you at least consider putting in the maximum tax on earned income at 50 percent, not because the Treasury thought that there should be the distinction between and in that common investment income, but we just thought that the votes might be there at least to do that as a minimum.

But, I don't think there was any desire at the time to limit it on any philosophical basis on earned income.

Senator LONG. Since that time, people have asked me well, why would you discriminate against unearned income and I have told them that they just didn't understand that the people who put that provision in there had their interest at heart, too, that's just all we could get at the time. We should have tried to do more to encourage production and productivity.

One reason that this bill is needed, is, here we failed to do what we should have been doing then. I didn't vote to knock out everything that would give rate reductions, but that's how it worked out, and you didn't want that to happen either. I see you nodding.

Mr. COHEN. That's correct. The rate reduction as I recall it was left in when the bill left the Senate Finance Committee who was deluded on the floor of the Senate in favor of an increase in the personal exemption.

Senator LONG. The amusing thing about it, the man who offered the amendment referred to that point, as his greatest victory in his entire service in the Senate and that's the year he got beat for office.

Mr. COHEN. That's correct.

Senator LONG. Which tends to prove what I've been saying, that those things that sound so great—but don't always get you elected.

Mr. COHEN. You know more about that than I Senator.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman. I regret that other commitments have kept me away from hearing the testimony of all our witnesses, I wanted particularly to introduce a dear friend, a particularly able, and respected constituent, Ralph Saul, the chief executive officer and chairman of the INA Corp. from Philadelphia. He has had an extremely distinguished and unique career. He was a foreign service officer in Czechoslovakia. He was a member of the staff of the Securities and Exchange Commission. He was promoted with one intermediate stop to be president of the stock exchange. In addition, has been an important civic leader too.

He has served on many committees for economic development. He is also a trustee of the University of Pennsylvania. It is indeed an honor and privilege to have him here.

I did, however, have the opportunity to read his statement on the rather unique proposal that he has made, which combines an IRA with a way of making social security more solvent in the long run. And I know that the Insurance Company of North America is something of an expert on actuarial calculations. [Laughter.]

At least I hope they are for their sake.

I was wondering if you had some specific estimates, Mr. Saul, on the kind of reductions in social security expenditures which your proposal would make possible—but only on a voluntary basis, since no cuts would be mandatory. Instead, to the extent that you took advantage of an SSOA, would you forgo some future benefits under social security.

I see that you have the range $10 to $25 billion as an annual reduction in the year 2005. Now that's fairly wide. What is the reason for the width of that range? Is it that you are having difficulty anticipating how many people will take advantage of this option?

Mr. SAUL. That's right, Senator; yes. There were various assumptions made and I think that the number of participants is one of the key variables. I think if you read the study, you'll see that there are a number of assumptions that have been made in determining the gains to the social security trust fund by the year 2005.

But just to simplify it for purposes of this hearing, our conclusion was that for every dollar of revenue loss to the Treasury, that there would be a $2.50 gain to the social security trust fund.

Senator HEINZ. Now, in the summary of your statement here, it indicates that in 10 years the SSOA program would produce a capital pool of between $40 and $100 million in 1981 dollars. That sounds like a typo. Should it be in millions or billions. We aren't use to dealing in such small numbers.

Mr. SAUL. That is the actuarial calculation assuming that certain people decide to forfeit social security and set up a social security option account.

Senator HEINZ. Well, that is a very modest projection. Is there any chance it could be substantially more?

Mr. SAUL. Yes; it should be billion. I'm sorry.

Senator HEINZ. Well, you now fit right in with all the other witnesses. [Laughter.]

As I was saying, that is a lot of money. [Laughter.]

Mr. SAUL. I thought you said a billion in your original question.

Senator HEINZ. Have you estimated the differences in what this would bring about compared to what proposals to enlarge IRA benefits would achieve?

Mr. SAUL. No, we have not, Senator.

Our feeling has been that one approach to individual retirement planning should be to link it to reducing the strains on the social security system. If you could do that—in other words, if you could come up with a long-term program to link reduction in the strains on the social security system, strengthen the social security system with incentives for indvidual retirement planning, that would be a highly desirable outcome. That was the premise upon which we did this study. We had a hypotheses and we think our hypotheses has been confirmed by the actuarial studies that have been done.

Obviously, there are many key factors that would influence an individual's decision as to whether he wanted to forfeit social security benefits, including his marginal tax rate, his age—younger people would have maybe a different incentive than older people—and obviously the level at which you set forfeiture.

If forfeiture is set much too low, you'll encourage too many people to forfeit with considerable loss to the Treasury. If you set it too high, most people won't forfeit except the very wealthy.

So we came up with a proposed one-half of 1 percent forfeiture rate. As a forfeiture rate that would achieve the multiple objectives of strengthening social security and encouraging people to set up SSOA's.

Senator HEINZ. Well, Mr. Chairman, I think this is an extremely creative approach. While it's just a first impression, I like what I see. If any of the other witnesses in the panel wants to make any comments, constructive, critical or otherwise, I am sure we would like to have them.

Mr. SILVER. I would never disagree with my old boss, Ralph Saul, and I think his proposal is worthy of study but we do have as a matter of fact cost estimates of the universalized IRA. Specifically the one embodied in S. 243 which would envisage a modest deduction of $2,000.

The estimates of revenue cost, ours I think are similar to the Joint Committee staff, are about $3.5 billion. It does seem according to the studies that we have had performed, that a universal IRA would be remarkably cost effective leading to increased savings in the neighborhood of $20 billion. Two studies, one by Professor Boskin and one by Michael Evans seem to agree on that point.

Senator HEINZ. Any other comments.

Mr. FEY. It's a very—concept. I think it needs to be investigated very thoroughly and it needs to be fully integrated with the IRA legislation and all the other changes that might be made in the individual retirement accounts.

Senator HEINZ. Mr. Chairman, thank you very much. Ralph it's good to have you here.

The CHAIRMAN. I want to thank the members of the panel and I think no doubt about it we are going to be adopting a hopefully, more incentives for saving, that seems to be—are you all prepared to wait for the second train, does that——

Mr. FEY. I think we definitely should not particularly—the administration's program apart. I think that we would make the

mistake if we fragmented. I think our tax relief in the first conceptions should be general and that we should await for the second bill.

Mr. SILVER. My only thought is, Senator, from what you said earlier, I simply hope that the well is not empty of individual tax relief when this does come for consideration. That you at least reserve some portion of revenue loss to consider a savings plan because I think savings plans have a useful place in the new emerging tax game.

The CHAIRMAN. I think that—I can't speak for the administration, but it is my understanding that if there was some agreement to proceed in that fashion that there would be funding available for the second package.

Mr. MORRIS. Senator, I would like to make a comment. We are concerned from the savings and loan business standpoint, about waiting for the second train. We feel like the homebuyers and our institutions need help on a more immediate basis and we feel that the proposal we have set forth will give immediate help to lowering the cost of funds for borrowers through the tax exemption on the savings account.

We are concerned about waiting for the second train.

Mr. SAUL. Mr. Chairman, let me just make one statement. I feel very strongly that the Congress ought to pass the President's program. I think that should be phase 1.

I think in phase 2—one of the primary issues that Congress is going to have to deal with, and obviously the administration has already given you a set of proposals, is the social security system. The proposal we are recommending should be taken up in the context.

The CHAIRMAN. I think that is phase 3.

Mr. SAUL. That's phase 3.

[The statements of the preceding panel follow:]

STATEMENT OF DAVID SILVER
ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE SENATE COMMITTEE ON FINANCE

May 19, 1981

My name is David Silver. I am President of the Investment Company Institute. I am accompanied by Edwin S. Cohen, outside tax counsel to the Institute for some forty years.

The Institute is the national association of the mutual fund industry. Its membership includes 571 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of about $160 billion and have approximately 12 million shareholders. Thus, the average mutual fund shareholder account size is about $13,300.

Mutual funds provide an economical way by which an investor of modest means can obtain the same professional advice and diversification of investments as a wealthy individual or institution. A wealthy person can retain an investment adviser to select and manage his or her investments, and by investing in a number of different securities can achieve diversification of risk. Mutual funds are designed to permit thousands of investors to pool their resources as

shareholders in a fund which in turn invests in a large number of stocks or debt instruments under the supervision of a professional investment adviser. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of the gross income generated by the fund's investments, less the fund's operating expenses such as investment advisory, custodial and accounting fees.

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

Mutual funds distribute their income, including capital gains as well as ordinary income, currently to their shareholders. In order to avoid placing a federal income tax burden on persons investing through mutual funds that would be heavier than the tax burden on persons who could afford to invest directly, the Internal Revenue Code for some forty years has treated mutual funds essentially as conduits. Known in

the Code as "regulated investment companies," mutual funds are relieved of federal income tax at the company level if they meet various specified requirements, including prescribed diversification of their investments, provided they currently distribute all their income to their shareholders. Each mutual fund shareholder then reflects in his or her own return the income he or she receives from the fund. The government thus obtains essentially the same revenue as if the person invested directly in a pro rata portion of the mutual fund's investment portfolio.

The President has submitted important proposals for revision of the federal tax laws through adoption of a capital cost recovery system for machinery and equipment and an across-the-board reduction in individual income tax rates. The President has asked that those proposals be acted upon first, and that other important changes in the tax law be deferred to a second bill. Secretary Regan indicated that the Administration is committed to a second bill, and the President has pledged to seek additional tax changes. However, we understand there is a possibility that the Committee may decide to include other provisions in the first bill, and if this should occur we trust the Committee will give high priority to including in the bill the liberalization of retirement accounts that are embodied in S.243, introduced

SUMMARY OF PRINCIPAL POINTS IN
STATEMENT OF DAVID SILVER
ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE COMMITTEE ON FINANCE

May 19, 1981

To increase savings and investment, aid capital formation, provide retirement income and meet family needs for housing and education, the Congress should enact S. 243. The bill would make permanent the $200/$400 dividend and interest exclusion, increase it to $500/$1,000 for taxpayers age 65 or over and expand the existing Individual Retirement Account (IRA) system by -

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

- Increasing the deductible contributions to IRAs (now 15% of earned income with a maximum of $1,500) to the total amount of earned income with maximum of $2,000; and allow nondeductible contributions up to $2,000 a year plus an additional lifetime amount of $8,000. Increasing the maximum size of IRAs will reduce the expense ratio in the maintenance of the accounts and encourage their promotion and use. Nondeductible contributions are permitted in employer plans and Keogh plans and should also be permitted in IRAs.

- Permitting limited withdrawals from IRAs without the present 10% penalty tax (a) to purchase a first home or (b) to pay for higher education or vocational training of children. This would encourage use of IRAs, particularly by persons with moderate incomes in their early working years, because it would prevent a complete lock-in of the funds to age 59-1/2 if they become necessary for these two prime family needs.

These changes, readily accomplished within the existing IRA structure, would greatly increase the use of IRAs. They would be neutral as between various forms of investment, would increase savings for retirement, housing and education and would significantly aid in capital formation. Thus, S. 243 will provide the type of economic stimulus that the nation so urgently needs.

January 23, 1981 by Senator Chafee. If the Committee confines the first bill to the President's two proposals, we trust S.243 will be given favorable consideration in the second bill.

The Institute strongly supports S.243 and an identical bill, H.R.1250, introduced by Congressman Moore. These bills would modify the federal income tax laws to promote capital formation through increases in savings and investment. Personal savings by United States citizens as a percentage of disposable income fell during the years 1977-1980 to the lowest level since 1963. Our savings rate is lower than that in other major countries, including Canada, West Germany, France and Japan. Moreover, from 1970 through 1978 our productivity growth was less than that of any of our seven major trading partners except for Great Britain. The decline in productivity is a major national problem.

To overcome the problems stemming from reduced productivity and savings, and to promote capital formation, expand job opportunities, and improve our ability to compete with other countries, we believe the federal tax law should be modified to provide further encouragement for individual savings in a manner that would serve socially desirable and anti-inflationary purposes such as providing for retirement, housing and education. S.243 accomplishes these objectives readily and simply by building on existing programs without creating new tax structures.

First of all, the bill makes permanent the exclusion from tax of the first $200 ($400 on a joint return) of dividend and interest income and increases that amount to $500 ($1,000 on a joint return) when an individual or spouse attains the age of 65. The $200/$400 exclusion was enacted as part of the Windfall Profit Tax Act of 1980 for taxable years beginning after December 31, 1980 and before January 1, 1983 and must be made permanent to assure taxpayers that current levels of savings and investments will continue to be encouraged. Expansion of the exclusion for those over 65 will further stimulate private savings for retirement.

Additionally, the bill expands the use of the existing Individual Retirement Account (IRA) system by eliminating the provision that prohibits its use by anyone who is an "active participant" in a qualified employer plan. IRAs were introduced in ERISA in 1974 as a result of a Treasury proposal in 1971 to permit retirement savings by persons who either were not covered by employer-sponsored qualified plans or for whom the employer contributions were less than $1500. However, the difficulty of measuring the employer contribution by an employee in many plans led the Congress to make ineligible for IRAs all employees who are "active participants" in employer plans. This provision has created serious

administrative complexities and has operated unfairly in many instances.

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

Currently deductible contributions to IRAs are limited to the lesser of $1500 or 15 percent of earned income. One of the major drawbacks to existing IRAs is that the $1500 ceiling on annual contributions is too low. This low ceiling means that the necessary expenses of maintaining

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* If the employee prefers, and if the employer's plan allows, the bill permits the employee to place his deductible contribution in his employer's plan rather than his own IRA. To be deductible, this contribution must be in excess of any contributions which are required as a condition of employment, as a condition of participation in the plan or as a condition of obtaining benefits under the plan attributable to employer contributions.

IRA accounts in a bank, insurance company or mutual fund is high in relation to the income on the $1500 investment. Further, the small size of the account does not provide adequate incentive to those who would incur the expense of advertising the availability of the accounts and promoting their use. Finally, the tax advantages to the owner of such a small account are too limited to be a meaningful encouragment, particularly in light of the inflation that has occurred since 1974. Dollar limits for contributions and benefits under corporate plans are indexed under present law, but those for self-employed plans and IRAs have been confined to their 1974 levels, although inflation has eaten into their value by some 40 percent. S.243 raises the ceiling on deductible contributions to an IRA to the lesser of $2,000 or the amount of compensation earned by the taxpayer during the taxable year. Permitting the taxpayer to enlarge the size of the account by depositing larger deductible contributions materially lowers the expense ratio in the account and induces sponsors of the account to promote their use.

In addition to the increased deductible contribution, S.243 permits nondeductible contributions to an IRA of $2,000 per year, plus an additional $8,000 over the taxpayer's lifetime. Under existing law, nondeductible contributions are permitted to be made by employees to qualified pension and

profit sharing plans and to plans for the self-employed. They should be permitted similarly for IRAs as a means of encouraging additional retirement savings and investment, and increasing the size of the IRA to further absorb the costs of maintaining the accounts and encouraging their use. A nondeductible contribution costs no revenue when it is made, although the tax in future years on interest, dividends and capital gains received on the investment of that contribution will be deferred until retirement years.

S.243 permits withdrawal, up to a lifetime maximum of $10,000, from an IRA without penalty if the withdrawn amount is used either (a) to purchase a first home or (b) to pay for the post-high school education or vocational training of a child of the taxpayer. Withdrawals must be made in increments of at least $2,000 and the value of the account must be at least $2,000 immediately after the withdrawal. The IRA rules now prohibit withdrawal of any amounts by the taxpayer prior to his attaining age 59-1/2, except in the case of death or disability. Amounts withdrawn for other reasons are subject to a 10% withdrawal penalty tax. This is a severe penalty -- superimposed on the regular income tax that must be paid on the withdrawn amounts -- and undoubtedly has a discouraging effect upon the savings of persons of moderate incomes, especially in their early working years, who are

concerned about locking up funds until age 59-1/2. Two principal concerns of these groups are the need for a down payment to purchase a first home and the financing of higher education for their children. Permitting limited withdrawals up to an aggregate of $10,000 without a penalty tax should alleviate their concerns about the lock-in to age 59-1/2.

Little or no revenue is obtained from the existing penalty, and its removal in these two cases should greatly stimulate the use of IRAs without seriously affecting long-term retirement plans. Amounts withdrawn, to the extent that they exceed the taxpayer's total nondeductible contributions to the account, would be includible in income, though without penalty tax -- a factor which encourages retention of funds in the final account until retirement age without making withdrawal for purchase of a home or higher education prohibitively expensive.

The tax cut fashioned by S.243 would not be inflationary. By stimulating the use of IRAs, taxpayers would be encouraged to save; once in an IRA, funds would be invested rather than spent. Thus, there would be more money saved for capital formation, housing, education and retirement and less spent for consumption. We strongly urge that our nation's tax structure begin to encourage saving and investing over immediate consumption through the enactment of S.243.

Michael J. Boskin, Professor of Economics at Stanford University, has studied the economic impact of S.243. His study indicates that, if enacted, S.243 will result in a savings gain of nearly $20 billion or more over the next few years. Professor Boskin concluded that: "the newly generated saving, especially as it cumulates over several years will provide an urgently needed increase in the flow of funds available for private capital formation in the U.S. This in turn will stimulate productivity, increase GNP (and, ultimately provide tax revenue reflows) and lead to more remunerative employment for American workers." Professor Boskin's study is attached to our written statement. We further note that Michael Evans of Evans Economics, Inc., has studied H.R.1250 and submitted his findings to the House Ways and Means Committee. Mr. Evans reaches substantially the same conclusions as Professor Boskin.

In sum, we believe S.243 has major advantages in the cause of capital formation and the promotion of savings and investment because -

- It utilizes the existing IRA structure without requiring a new type of account with new rules and regulations to be promulgated.

- It eliminates or modifies existing IRA provisions that have caused administrative complexities, that have significantly reduced the number of eligible users and that have caused the necessary expense of promoting and maintaining the accounts to be high in relation to their permitted size.

- It is neutral as between various applications of IRA funds -- common stocks, preferred stocks, various types of debt instruments, government obligations, bank deposits, insured annuities, etc.

- It permits an employee who is an active participant in an employer plan to choose to make his contribution to the employer's plan or to his own IRA, and thus is neutral as between the use of a separate account or the employer plan.

- It permits some withdrawal, without tax penalty in excess of the usual income tax, of funds for prime family needs of purchasing a first home or higher education or vocational training of children.

- It permits accumulation of investment income, including roll-over of capital gains, on funds in the account with reasonable ceilings placed on the amounts of deductible and non-deductible contributions.

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

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

Analysis of the Savings and Retirement Income Incentives Act of 1981

by

Michael J. Boskin
Professor of Economics
Stanford University

March 1981

The United States has the lowest private saving rate of any advanced economy; in recent years, the personal saving rate has fallen still further; both to provide a source of income in later years (especially retirement) and to help finance badly needed capital formation, it is widely recognized that an increase in our saving rate is an extremely high priority. The Savings and Retirement Income Incentive Act of 1981 contains a variety of features designed to encourage saving. The extent to which it does so depends upon the extent to which each of its provisions reaches a substantial fraction of the population; the nature of the changes in the incentives these people face; and their response to these changed incentives. The major provisions of the Bill are as follows:

A. Liberalization of Individual Retirement Accounts.

1. Allows all employees to start an IRA;

2. Increases deductible limit to $2,000;

3. Eliminates 15% ceiling;

4. Allows supplemental non-deductible annual contributions up to $2,000; and $8,000 lifetime additional;

5. Allows withdrawals prior to age 59 1/2 of up to $10,000 under certain conditions.

B. Makes the $200 interest/dividend exclusion permanent and increases it to $500 for taxpayers over age 65 (double these for joint returns).

For each of these aspects of the Bill, it is necessary to determine the taxpayers who will be affected; how they well be affected; and their response to these changed incentives. Using a variety of data sources, usually from the year 1976 (then updated to the present) such as the

Statistics of Income, special supplemental reports on Individual Retirement Accounts, etc., I determine for each of these provisions the number of individuals likely to be affected; the likely change in the incentives they face - both in terms of their after-tax income and the effective after-tax after-inflation rate of return on their saving opportunities; and, their likely response to such changes. It is important to note that at each stage of this process, a variety of assumptions must be made. For example, once we determine how many newly eligible for expanded IRA coverage returns there will be, we still have to assume an interest elasticity of private saving, an effective tax rate, a distribution of current savings in the population newly affected, etc., in order to derive the change in aggregate saving the provision will induce. These assumptions are discussed below.

The effect on saving from expanding coverage would create approximately 33 million newly eligible returns. I estimate under what I consider to be the most reasonable set of assumptions an aggregate annual increase in saving of approximately 10.3 billion dollars. This number is derived by taking the distribution of saving for newly and previously eligible returns to be the same; and assumes that approximately one-half of those households currently saving zero will have some response to the availability of an IRA. We have also assumed a modest interest elasticity of saving of 0.4. [1]

[1] To test the sensitivity of our results to variations in the assumptions, we note that assuming a larger interest elasticity of saving, such as 1.0, would increase the aggregate saving response by approximately 60%; assuming that all of those who are currently saving zero respond would increase the response by about 50%; assuming that none do would reduce it by approximately 50%. Assuming that participation rates under the newly available IRA's would remain at the participation rates of 1976 for those then eligible for IRA's would reduce our figures about one-quarter of the total presented above. However, IRA participation has apparently expanded greatly since 1976; the likely development of increased IRA participation by spouses; the preferable liquidity features under the proposed law, etc., all suggest that participation rates are likely to be larger than they were in 1976 under the existing law.

Approximately 45% of those who are already eligible for IRA participation contribute the maximum. By taking the distribution of those already saving $2,000, or greater than 15% of AGI, we can estimate those who may be "constrained" by the limit. This leads to an estimated saving increase of 0.4 billion dollars.

The non-deductible contribution is also likely to encourage saving substantially. This occurs because the interest on the non-deductible part of contribution is not taxed on accrual, and hence the effective after-tax, after-inflation rate of return on such contributions is greater than that on ordinary saving taxed on accrual under current law. Once again, the size of the estimated response depends upon assumptions about how those currently saving zero will respond, the assumed interest elasticity, etc. My best estimate is that this provision of the Act will encourage approximately 7 billion dollars of saving annually.

The effect of the special exclusion for those over age 65 is unlikely to be large because the overwhelming bulk of those over age 65 receive interest and dividends beyond the exclusion; hence, there would be no rate of return effect for them. Further, the elderly have higher propensities to consume than the average. The total increase in saving would certainly be less than one billion dollars.

The effect of making the interest/dividend exclusion permanent relative to having it expire as under current law, is difficult to estimate because data for the very recent past on the distribution of interest and dividend receipts is difficult to come by. Using data from even a few years ago, given the substantial increase in interest rates and nominal asset values in last several years, could make the estimate quite misleading. It is

important to note that a substantial fraction of the low and moderate income population receives less than the $200/$400 limit, because their saving both annually and in the aggregate is quite modest. For this group, a price effect would be created and we would expect some increase in their saving. My own best guess is that perhaps another billion dollars or so would be generated under such a scenario.

Thus, a best guess aggregate effect would be as follows:

Saving gain from:	
Expanded coverage	10.3 billion
Increased limit for those currently eligible	0.4 billion
Non-deductible option	7.0 billion
Dividend/Interest exclusion (of which maximum of $1 billion due to extra exclusion of elderly)	2.0 billion
TOTAL (in 1976 dollars)	19.7 billion per year*

The estimated annual increase amounts to approximately 28% of personal saving based on 1976 saving levels; and perhaps slightly more based on the current lower personal saving rate. Therefore, it appears that the impetus for saving will be substantial and very cost-effective from the expansion of IRA coverage and the inclusion of the non-deductibility option. The key is to broaden participation in such programs.

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* Changing this total to 1981 dollars, using the GNP deflator would result in an increase of approximately 40% between 1976 and early 1981.

These estimates refer to the eventual, or steady-state response, to the incentives in this Act. I would expect it to take several years before the full impact was reached; it is not possible to estimate precisely the time pattern of movement to these levels. Hence, for example, they should not be construed as fully applicable to the next year or two.

Any tax legislation such as the one currently being analyzed, which shifts the disposition of income away from spending toward saving will lessen the potential inflationary impact of a tax reduction. While the additional saving, and decreased consumption, are of modest magnitude, and should not be thought of as the major vehicle for fighting inflation (that job falls primarily on the FED's monetary policy), our current and prospective inflation situation is bad enough to warrant additional consideration for saving incentives to assist other anti-inflationary policies.

Further, the newly generated saving, especially as it cumulates over several years will provide an urgently needed increase in the flow of funds available for private capital formation in the U.S. This in turn will stimulate productivity, increase future GNP (and, ultimately provide tax revenue reflows) and lead to more remunerative employment for American workers.

Technical Appendix

As mentioned above the impact of each of the features of the Savings and Retirement Income Incentive Act of 1981 depends upon three factors:

1. The extent to which each feature affects various groups in the population;

2. The nature and extent of these effects, e.g., changes in after-tax rates of return;

3. The response of the affected groups to these changes in incentives.

For each of the features we have attempted to gather the most salient information from which to estimate the likely effects on aggregate private saving and on saving by adjusted gross income class. We start by noting some basic facts about current eligibility and use of Individual Retirement Accounts. These data are summarized in Table 1. The most important point to note that while a substantial fraction of the population are eligible for IRA usage, this fraction is greatest in the lower and middle income classes, which groups thus far have very low participation rates in Individual Retirement Accounts compared to upper income groups, (see Table 1).

Next we must decompose the incentive effects of the individual provisions into their effects on their after-tax expected rate of return and on after-tax income. Eligibility for Individual Retirement Accounts, for those not currently eligible, implies that at the margin the individual or family may save at the before, rather than at the after, tax rate of return. Such long-term saving as embodied in IRA accounts means that the tax-induced differential in rates of return, compounded over the normal length of time between saving and dissaving[1] leads to enormous differences in the cost to

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[1] It is assumed to be 20 years for the purpose of this calculation.

Table 1.

Data on Current IRA Eligibility and Use

A. Who is currently eligible?

[Sources: President Commission on Pension Policy and 1976 Statistics of Income]

Adjusted Gross Income Class ($000)	0-5	5-10	10-15	15-20	20-50	50+
# of Tax Returns in AGI Class (000's)	23935	19893	14552	11197	13918	1175
% eligible for IRA's	85.0	70.0	60.0	45.4	24.9	28.6
#of returns with eligible individuals (000's)	20345	13925	8731	5083	3466	336

Total # (in 000's) of returns with eligible individuals: 51,886; % eligible: 61:3

B. Who had set up IRA's by 1976?

[Source: 1976 Statistics of Income Supplement: Individual Retirement Arrangements and President's Commission on Pension Policy]

AGI Class:	0-5	5-10	10-15	15-20	20-50	50+
% eligible who have IRA :	0.2	1.3	3.3	5.5	21.7	52.4
% returns who have IRA:	0.17	0.9	2.0	2.5	5.4	15.0
# Returns with IRA (000's):	42	180	284	299	767	147

Total # of returns (000's) with IRA: 1724; % of eligible=3.3; % total returns=2.0

cont. of Table 1.

C. How much was contributed in 1976?

[Source: 1976 Statistics of Income Supplement: Individual Retirement Arrangements]

Amount Contributed ($000's) :	26872	141040	259469	321323	997217	223298
Average dollar contribution per return:	640	784	907	1075	1300	1519

Total Contribution in 1976: $1.970 billion. Average Contribution per return: $1143. Average Contribution per IRA: $1052.

a family of purchasing future consumption by setting aside funds today in an IRA account as opposed to a fully taxable account. It is important, however, to note that for those groups currently dissaving or saving substantially more than the limit to the IRA account, this after-tax rate of return effect will not exist. Further, for those currently saving, net of borrowing, zero, the response to an increase in the potential after-tax rate of return to saving may not be identical to that of those already saving positive amounts. Therefore, we will present some sensitivity analyses to this effect below.

The impact of raising the limit to $2,000 and eliminating the 15% of AGI limit on those currently eligible for IRA participation are rather straightforward. For those who have not set up an Individual Retirement Account, there should be no impact unless there are large fixed costs for setting up an IRA. We would expect, as discussed below, some of the features of the Act to encourage participation for those who have not already set up an IRA.

For those who have an IRA, who plan to contribute less than the current limit, expansion of the limit should not induce any additional saving. For those who are at the limit, a very large fraction, approximately 45% of the total, we would expect the effects to be the familiar after-tax rate of return and income effects discussed above.

As noted above, some of the features of the Act are likely to encourage participation and contribution. Perhaps one of the most important is that of allowing early withdrawal without penalty under certain circumstances. The lack of this option under current IRA regulations certainly discourages IRA participation among lower and middle income groups in the population, who are not willing to sacrifice liquidity in order to achieve the higher after-tax return.

It is important to note also that the allowances for non-deductible contributions also have a rate of return effect. While the non-deductible contribution will not raise the after-tax rate of return on such saving by nearly as much as the deductible contribution, the fact that the non-deductible contributions will earn interest which will not be taxed on accrual implies that their after-tax rate of return will also be higher than that on normal saving vehicles. It is also important to note that the analysis discussed above is applicable, albeit with a lower net of tax increase in the rate of return, and is only applicable to those who would contribute the maximum to the Individual Retirement Account.

In moving from current IRA eligibility and use to analyze the impact of the new incentives on saving, we need to work through data on saving rates, marginal tax rates, etc. The personal saving rate has fallen to a post-War low in the last few quarters. We use our estimate of net financial investment to disposable income of 6% in most of our calculations, which is slightly higher than the current saving rate, equal to that derived from the Federal Reserve Flow of Funds for 1978 and somewhat lower than the saving rates of the early and mid-1970's. We believe this to be a reasonable rough estimate averaged over the next few years of the average personal saving rate.

In order to know the extent to which the after-tax rate of return has been increased by the availability or extension of coverage for the non-deductible option in the IRA, we need to know the average marginal tax rate in each AGI class. From the 1976 Statistics of Income, we note in Table 2 the weighted average marginal tax rate by AGI class. These tax rates have probably risen slightly since then, and obviously are undergoing scrutiny at the moment. The increases since 1976 will not have a

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Table 2.

Weighted Average Marginal Tax Rates

[Source: 1976 Statistics of Income]

AGI Class	0-5	5-10	10-15	15-20	20-50	50+
Average Marginal Tax Rate	5.54	18.03	21.41	23.69	30.18	51.28

large impact on the calculations below, but it should be noted that any bias in our estimated saving response will be on the low side since the tax disadvantage of ordinary types of saving vehicles with higher tax rates will be still greater relative to an IRA.

We must next analyze saving in the different AGI classes in order to estimate the potential impact of these features of the IRA expansion by AGI class. Table 3 presents a rough estimate of the distribution of savers among those who are dissaving, saving zero, and saving various positive fractions of their AGI. As can be noted from Table 3, a substantial percentage of returns, especially at the lower income class levels are not saving positive amounts. Therefore, we must make some assumptions about how those saving zero will respond relative to those currently saving positive amounts. We present three such estimates below.

Using the information above, we can calculate the change in the effective after-tax real rate of return to saving and real net income from the expansion of IRA coverage, the availability of the non-deductible provision, etc. by AGI class. This will tell us what the net change in the incentives faced by the typical individual in each AGI class would be. Using the distribution of saving, as discussed above, and different assumptions about the rate of return elasticity of private saving, we can calculate the change in saving induced in each AGI class and the aggregate change in saving for expanding coverage. (See Table 4.)

It is clear that the size of the response, as estimated with a moderate interest elasticity of 0.4, will be quite substantial to the expansion of coverage even if those saving zero currently do not respond and participation rates are no larger than those estimated in 1976 for current eligibles. There is substantial reason to believe that at least some fraction of those saving zero will respond, and that the participation rates are likely to

Table 3.

Distribution of Savers. [Source: Feldstein + Feenberg + assumptions]

Ratio of Change in Financial Assets	AGI Class 0-5	5-10	10-15	15-20	20-50	50+
	Percent of returns					
<0	23	23	24	26	24	20
0	46	46	40	31	25	21
0-.04	11	11	16	20	19	22
.04-.10	6	6	8	10	11	9
.10-.18	4	4	4	4	9	6
.18-.36	4	4	4	5	7	10
>.36	6	6	4	4	6	12

Table 4.

Change In Saving for Expanding Coverage

Assumptions: All newly eligible with positive post-IRA desired saving participate.		Total (in billions)
Interest elasticity: 0.4		
Those saving zero: respond	(1)	$15.3
: 1/2 respond	(2)	10.3
: don't respond	(3)	5.3
Interest elasticity: 1.0; zeros respond	(4)	23.9
Participation rates among newly eligible same as current, by AGI class; interest elasticity = 0.4; zeros respond	(5)	2.9

By AGI Class, as examples (Cases (1) and (3) above):

AGI Class	0-5	5-10	10-15	15-20	20-50	50+
(in $million)						
Case (1)	32	895	2305	3595	8006	400
Case (3)	0	36	728	1504	2989	48

be higher; we have noted a liquidity effect above; it is also the case that a spouse will now be able to set up an IRA account rather than just enable a current participant to slightly extend their contribution. Therefore, I would expect participation rates to be much higher eventually under the proposed legislation than under the current situation. It is also clear that a still larger interest elasticity, for example, the 1.0 presented would cause a substantially larger increase. My own best estimate from these considerations would correspond to the moderate interest elasticity, and assuming approximately one-half of those currently saving zero eventually respond to the IRA coverage by setting one up for moderate amounts. This leads to an implied increase in saving from the expansion of coverage to those not currently eligible of $10.3 billion.

Raising the limit for those already eligible will have only a negligible impact. 45% of those who already have IRAs contribute the maximum, and a substantial fraction of these are already saving at least $2,000. Some of these may be saving the additional funds in taxable forms and hence, may have a slight reduction in their rate. Our estimate, working through these calculations by AGI class, concludes that the increase in saving from an increase of the limit to $2,000 for those already eligible will amount to only 0.3 billion dollars.

The $2,000 annual non-deductible contribution (and correspondingly, the one-time lifetime additional $8,000 contribution) may increase utilization if fixed costs are large and will have the modest after-tax rate of return effect discussed above, smaller than that for the deductible contribution, but since the interest is not taxed on accrual, higher after-tax rate of return than many other saving vehicles. Once again we work through the analysis by calculating the change in the after-tax return for taxpayers in each

AGI class, given their marginal tax rates calculated above, and present estimates of the total increase in saving due to the $2,000 non-deductible contribution. This amount would be buttressed somewhat by the $8,000 lifetime contribution addition,but we made no separate calculation of this effect. Table 5 presents these estimates by AGI class under the assumptions that all currently eligible who are at the limit will move to the new limit, that the $2,000 non-deductible contribution is marginal, and that all positive savers who are newly eligible will participate. As noted above, lower participation rates would decrease these percentages accordingly. We present for sensitivity analysis purposes our estimates based on our preferred set of estimates of 0.4 elasticity of saving and also for the somewhat larger 1.0 elasticity and various scenarios with respect to the responses to those currently saving zero.

The effect on saving of the $500.00 interest and dividend exclusion for taxpayers over 65 (double this for joint returns) is likely to have a very small impact on aggregate saving for two reasons:

1. It is infra-marginal for a large fraction, and thus without any rate of return effect, and those whose rates of return are changed are unlikely to increase saving, at least if they are already retired.

2. The income effect on saving will also be small since the elderly would be expected to have high marginal propensities to consume. As an example, from the 1976 Statistics of Income derived from a year when interestrrates were much lower than at present, we note that the average dividend and interest received even in the AGI class, 0 to $5,000, for persons with a household head of an age over 65, was $1,158; further, 80% of such returns had positive interest payments. The average interest and dividend increased substantially even among low and

Table 5.

Change In Saving From $2,000 Non-deductible

Interest Elasticity	Case	AGI Class 0-5	5-10	10-15	15-20	20-50	50+	Total (billions
		(in $million)						
0.4	zeros respond	0	78	188	578	6399		8.7
	zeros do not respond	0	78	188	578	4382		6.3
1.0	zeros respond	0	195	1293	4366	15983	1474	23.3

middle income elderly households so that the aggregate amount of the exclusion, while providing some minor tax relief for the elderly, will not change the after-tax rate of return on additional saving for many of them.

Making the $200 interest and dividend exclusion permanent (double these for joint returns) will effect the savings of those receiving very low interest and dividend payments through rate of return effects and also will have a small impact on aggregate saving through the tax reduction embodied in the exclusion of the interest and dividend from tax payments. It is extremely difficult to estimate this impact in the current economic scenario. This is because interest rates and nominal asset values have gone up so much, that the sources of information available on interest received and the average dollar amount of interest combined with information on saving behavior comes from the mid-1970's when interest rates were much lower. It is clear that a non-trivial part of the population has very small saving and also small interest and dividend returns and that these people will have an extra incentive to save. Even estimating the percentage of interest accruing to such individuals in 1980 by adjusting 1976 Statistics of Income data would be hazardous at best. Suffice it to say that our analysis makes several assumptions which deliberately err on the conservative side in doing so and still come up with a very modest impact of the interest and dividend exclusion. Indeed, it would be necessary to have a much larger interest and dividend exclusion in order to begin to cover a large fraction of taxpayers receiving positive interest payments and still larger an exclusion to cover the majority of interest and dividends received.

Finally, we might note that several assumptions have been used in these archetypal calculations and note how variations in these assumptions might effect the estimates presented above. First, we assume that the tax

rate at retirement is approximately half the individual's current rate of tax. This seems to be standard in much actuarial calculation concerning pension funds, etc. We assume a nominal interest rate of 10%, clearly below current market rates but similar to a reasonable average for the last few years, and a long-run inflation rate of 7%. We assume that the average number of years to dissolve the plan is 20. If it is the case that the after-tax, after-inflation rate of return on ordinary saving plans is still lower and the removal of the double taxation of saving via expansion of the IRA to newly eligible individuals will cause a still greater increase in the real after-tax rate of return, and hence a larger increase in saving than the numbers presented. I believe these estimates to be conservative for these reasons. If however, we believe that nominal interest rates and inflation rates will be much lower than 10 and 7 percent respectively in the near future, these estimates slightly overstate the effect on saving.

STATEMENT BY JOHN T. FEY, CHAIRMAN OF THE BOARD,
THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE U. S.,
ON BEHALF OF THE
AMERICAN COUNCIL OF LIFE INSURANCE
BEFORE THE
SENATE FINANCE COMMITTEE
REGARDING THE TAX ASPECTS OF THE PRESIDENT'S ECONOMIC PROGRAM

MAY 19, 1981

INTRODUCTION

I am John T. Fey, Chairman of the Board of the Equitable Life Assurance Society. Today I am appearing before your Committee on behalf of the American Council of Life Insurance. The Council has a membership of 519 life insurance companies which have, in the aggregate, 95 percent of the legal reserve life insurance in force and 97 percent of the total assets of all U. S. life insurance companies. At the end of 1980, total assets of the life insurance business aggregated more than $475 billion, invested mainly in corporate and government securities and mortgage loans to businesses and individuals. These funds represent the amounts that have been entrusted to our business by millions of individual policyholders and employee benefit plans. Our business has a vital interest in national economic policies to promote economic growth while reducing the high rate of inflation, and we welcome this opportunity to present our views to the Senate Finance Committee.

THE ADMINISTRATION'S TAX PROPOSALS

The life insurance industry applauds the bold initiatives taken by the Reagan Administration to cut down the growth of federal spending, to reduce the rising burden of taxation, and to eliminate counterproductive regulatory measures. We are particu-

larly pleased at the response in both houses of the Congress in the past two weeks to adopt budgetary measures designed to hold down the growth of both spending and taxation. The policy positions urged by our business through the American Council of Life Insurance have stressed these same basic objectives for many years.

The continuing increase in tax burdens is an important factor in restraining growth in the Nation's economic activity. The tax increases threaten to expand the burden of taxes on the U. S. economy by $50 billion or more. In our view, the Reagan proposals for a $54 billion reduction in individual and business taxes for fiscal year 1982 are both well-timed and of the appropriate magnitude, as an offset to the increases in the level of the tax burden on individuals that have taken place in recent years.

Tax changes can have a profound effect on the decisions of business and consumers to spend, to save, and to invest. In the interests of both fostering economic growth and productivity and curbing pressure on prices generally, we believe that tax changes in 1981 should be designed to provide at least as great a stimulus to saving and investment as to consumption. A significant liberalization of depreciation allowances, along the lines proposed by the Administration, would provide much needed encouragement to business investment. While the exact form of this legislation may require Congressional review over the next several weeks, we believe that prompt passage of liberalized depreciation rules, retroactive to January 1, is desirable to allow American business to move forward with greater certainty as a means of improving its capital base and raising the national level of productivity.

As to tax reductions for individuals, we endorse the Administration's program of reductions in personal tax rates, accompanied by sizable additional spending cuts designed to avoid unduly large deficits in later years. In our view, such reductions in tax rates are needed to offset the impact of inflation on the marginal tax rates payable by most Americans.

As previously noted, we particularly welcome the emphasis of the Reagan proposals on tax changes aimed at stimulating savings, as a means to encouraging capital formation and improving national productivity. There may be more than one way to provide greater incentives for savings, as for example through measures targeted toward that goal. Specifically, if the Congress should decide to develop additional tax legislation to supplement personal rate reductions, we strongly urge the enactment of an employee retirement savings deduction.

BENEFITS OF EMPLOYEE RETIREMENT SAVINGS DEDUCTION

As has been graphically demonstrated during the last several years, adequate retirement security for most Americans by Social Security alone is an unaffordable option. In addition to private pension plans, individual savings are necessary to reach the goal of an affordable retirement income system. With the current low rate of individual savings--Americans saved only 5.1 percent of disposable income as of the fourth quarter of 1980--tax incentives are needed to increase individual savings and improve the adequacy of retirement income for a broad cross section of Americans. It is important to note that most wage earners feel the current level of taxation keeps people from saving more.

Extending favorable tax treatment to employee contributions in all types of pension and profit sharing plans will increase savings among participants in these plans, thereby improving the adequacy of retirement income. In addition, an Employee Retirement Savings Deduction will reduce the pressures on Social Security, increase capital formation, provide a non-inflationary tax cut, and encourage new plan formation.

COMPONENTS OF LEGISLATION

There is a broad support, both in the House and Senate, for the concept of deductible employee contributions. Of the many bills introduced, the Council strongly prefers the "Employee Retirement Savings Contribution Act" (S. 1049), sponsored by Senators George Mitchell and David Durenberger, because it contains all the principles we believe are necessary for a successful retirement savings program. The bill authored by Chairman Dole, S. 12, contains most of the elements we believe are necessary for an effective program. The Council believes that any employee retirement savings program must be designed to stimulate high rates of participation and retirement savings. S. 1049 would be available to a broad cross-section of eligible employees and would be simple to administer.

First, any legislation should be simple for plan participants to understand with its purpose, provisions, and benefits widely known. This will help guard against a repeat of the IRA program's failure to be widely utilized. Second, the legislation should avoid unnecessary administrative requirements. Simplicity in this area will encourage employer sponsorship and, therefore, reach a large number of eligible employees at a wide range of income levels.

The deductible limit for employee contributions under S. 1049 would be equal to the IRA limit.

Making limits the same for plan participants and non-participants would eliminate any potential confusion on the part of employees as to the maximum amount that may be contributed for retirement savings and would simplify administration for employers and the government. It would also avoid any incentive to drop out of a plan in order to get a larger deduction.

Employees would be permitted to deduct both mandatory and voluntary contributions under S. 1049.

There are several significant benefits to be derived from allowing a deduction for mandatory contributions:

Establishment of new plans. Establishing new plans is important to the goal of meeting national retirement needs in future years. Employers, particularly small employers, often cannot afford the full cost of a pension plan in the early years of its operation. They are, however, more willing to set up plans where employees are required to contribute a portion of the cost as a condition of participating in the plan. Later, as the plan matures, the employer may pick up more of the cost of the plan. Thus, mandatory contributions are an important means of getting plans started.

This is especially true of small, new and marginally profitable employers, which is precisely the group of employers which do not now have retirement programs. If such employers cannot convince their employees to contribute to the pension plan, the employer will often be unable to establish such a plan. Moreover, if the employees' con-

tributions are not mandatory, it is often difficult for a small employer to sign up enough employees to qualify his pension plan even if he decides to institute one. Thus, if employers are to be encouraged to establish pension plans and if marginal employees and young employees are to be brought into the private retirement system, a deduction for mandatory employee contributions is important.

Improvement of existing plans. Many pension plans established in past years do not have adequate benefit levels. As with setting up new plans, many employers are often unwilling at first to make needed plan improvements unless their employees help to pay for the benefit increases. Then, in later years, the employers tend to pick up more of the cost of the improvements. Many employees need a deduction for their mandatory contributions if they are going to be able to afford to help their employers make these needed plan improvements. According to a recent Cambridge Report survey, 50% of the respondents currently participating in mandatory plans would expect to contribute more money if tax deductions were available.

There is no reason in basic tax philosophy why employer contributions should be favored over employee contributions. Allowing a deduction for mandatory employee contributions is an appropriate change toward tax neutrality between the two different sources of retirement funds.

Greater vesting for employees. Employers are more willing to set up or improve plans where employees contribute a portion of the cost. These contributions and earnings thereon are always fully vested. This provides a significant advantage to employees in plans in which vesting of employer contributions takes place only after a

fairly lengthy period of service.

Discouraging abandonment of plans. If a deduction were allowed for IRA contributions but not for mandatory plan contributions, some employees would be tempted to forego an employer's plan entirely, if he is required to contribute, in favor of IRA contributions because of the current tax benefit. According to the experience of one major employer with a contributory plan, the number of employees who dropped out of the plan and established an IRA leaped from approximately 1,500 in the 1970-1975 period to approximately 5,000 in 1976 when the tax advantages of the IRA became widely known. By the end of 1979, this number had grown to approximately 6,700 employees.

This erosion of plan participation will limit the growth and stability of plans. Moreover, it will often result in unwise decisions by employees who tend to look to immediate tax benefits and fail to evaluate properly the long-term benefits associated with membership in an employer-sponsored plan. A tax deduction for mandatory contributions would avoid these problems.

Avoiding distortions. Allowing a deduction for voluntary contributions but not for mandatory contributions may create an incentive for employers to convert their plans, which currently require mandatory contributions, to an arrangement where the employees contribute on a voluntary basis. The amended plan would provide benefits paid entirely by the employer, which would be less than the aggregate benefits provided under the original plan. The employees would then have an option to contribute the present level of contributions on a voluntary and hence fully deductible basis in order to have the same benefits as the original plan. This would result in diminished stability for plans and additional paperwork to no useful end. Not only would

new savings not result to the extent of the switch to voluntary contributions, but considerable damage would be done to the private pension system. Moreover, we can foresee the possibility of increased plan disqualifications, as younger employees decide not to participate in the plan on a voluntary basis.

CONCLUSION

The Council strongly believes that providing incentives for retirement savings will enhance the adequacy of employees' retirement income, thereby reducing the pressures on Social Security, will increase capital formation, will provide a noninflationary tax cut, and will stimulate new pension plan formation. Thus, should you decide to develop a bill that will provide more than the straight rate reduction as proposed by the Reagan Administration, we urge that an employee retirement savings deduction be given the fullest possible consideration.

We appreciate the opportunity to express the Council's views and would be happy to answer any questions the Committee might have or to furnish any additional information the Committee might desire.

STATEMENT OF JOE C. MORRIS
ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS
TO THE SENATE COMMITTEE ON FINANCE

May 19, 1981

Thank you, Mr. Chairman and members of this distinguished Committee. My name is Joe C. Morris. I am president of Columbia Savings Association of Emporia, Kansas, and appear today on behalf of the United States League of Savings Associations* where I serve on the Legislative Committee.

We appreciate this opportunity to present our views on proposals to encourage the savings and investment so necessary for stable, non-inflationary economic growth.

Many members of this distinguished Committee have demonstrated their support for savings incentives through the sponsorship of bills such as S. 12, S. 24, S. 142, S. 243, S. 330, S. 486, S. 638, S. 701, S. 888, S. 936, S. 1049 and S. 1072. Each of these bills contains features which will go far toward encouraging thrift among Americans as well as toward rebuilding the nation's badly depleted capital pool.

*The U.S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99% of the assets of the $625 billion savings and loan business. League membership includes all types of associations -- Federal, and state-chartered, stock and mtuual. The principal officers are: Rollin Barnard, President, Denver, Colo.; Roy Green, Vice Pres., Jacksonville, Fla.; Stuart Davis, Legislative Chairman, Beverly Hills, Cal.; William B. O'Connell, Executive Vice Pres., Chicago, Ill.; Arthur Edgeworth, Director-Washington Operations; Glen Troop, Legislative Director, Washington; and Phil Gasteyer, Assoc. Director-Washington Operations. League headquarters are at 111 E. Wacker Dr., Chicago, Ill. 60601. The Washington Office is located at 1709 New York Ave., N.W., Washington, D. C. 20006, Telephone: (202) 637-8900.

This Committee is familiar, I know, with the sad state of personal savings in our country. The latest monthly figure from the Commerce Department indicated that a mere 4 percent of disposable income was being saved in February. For 1980 it was 5.7%. Most recent available comparisons (1979) show that Canada had a savings rate of 13.9%, the United Kingdom 13.8%; West Germany 15.9% and Japan an impressive 26%.

There is no mystery to the savings' success in these, our industrial trading partners. Each utilizes favorable tax treatment to encourage citizens to save rather than consume.

Our tax laws and our inflationary experience in recent years combine to discourage personal savings. Consider this example:

> Assume that in January of 1980 you placed $10,000 in a six-month Money Market Certificate, the highest-rate retail savings, at the then-prevailing rate, 11.86%; assume further that you left the funds on deposit for another six months last July, when the rate was 8.59%. By January of this year you would have earned interest of $1,022.50, bringing your account total to $11,022.50
>
> Now, recall that the calendar year 1980 inflation rate was 12.4%. Your $11,022.50 savings account is worth only that much -- less the rate of inflation -- or only $9,655.71 in real purchasing power.
>
> Let us next assume that you are in the 25% tax bracket. This means that the Federal Government would take away 25% of the $1,022.50 interest income or $255.63. The saver is left with an account "worth" only $9,400.08.
>
> Thus, after inflation and Federal income taxation take their bites, the reward for savings is worth only 94 percent of the original amount conserved, rather than spent.

Inflation and the "buy now" psychology have depletd the flow of funds to thrift institutions -- savings and loan associations and mutual savings banks -- which provide the credit "backbone" for the housing sector of our economy and the bulk of the mortgages sought by families buying a home. The ability to provide home financing today is impaired by other factors, as well. Since the authorization of market-related savings in May 1978, the cost of acquiring funds has skyrocketed. Market-related funds -- particularly the short-term six-month Money Market Certificate -- now comprise over 60% of the deposit base of savings and loan associations. The MMC rate currently exceeds 15% -- providing an unacceptable floor under the mortgage rates which must be asked of new home borrowers.

At the same time, in performing our Congressionally-mandated function of home finance through the years, thrift institutions have acquired portfolios of long-term, fixed-rate mortgage loans -- investments still yielding 6%, 7%, and 8%. Even with the record mortgage rates of the recent past this "deadwood" depresses portfolio performance; roughly two-thirds of our loans yield less than 10%. The resulting, and much-publicized "earnings squueze" on our institutions severely handicaps our capacity to compete for funds and perform our specialized housing finance function.

The availabilility of funds for housing suffers from another development, too -- the explosive growth of unregulated money market mutual funds. The assets of these

funds now exceed $118 billion, with some $44 billion added somce tje first of the year. (By contrast, insured savings and loan associations experienced very substantial outflows in the first calendar quarter including an all-time monthly record loss of $2.3 billion in March. Not only are these funds "disintermediating" savings and loan associations and other depositories, they are creating "disinvestment" problems for the farms, businesses, and commerce throughout America. The deposits attracted away from hometown depositories by the fund managers are put in very short-term, high-yielding investment media, such as money center bank CDs (23%), commercial paper of giant corporations (33%), Eurodollars (11%) and deposits in domestic branches and agencies of giant, foreign banks (3%); ten percent or less of all fund investments are in U.S. Treasury securities (despite the fact that some institutional funds invest exclusively in Treasuries). Importantly, the money funds operate beyond the reach of our monetary control authorities and may, in fact, frustrate their efforts to combat inflation.

While I appreciate that imposition of reserves and other responses to the problems created by the unregulated money funds fall within the jurisdiction of other Congressional Committees, I feel that it is important that this Committee be aware of these problems. In your efforts to foster savings and capital formation, you should not indiscriminately extend further stimulus to their already explosive and disruptive growth.

The collapse of savings flows at our thrift institutions comes at a time when more people than ever before are entering the prime home buying years. A record 42 million people will reach the age of 30 during this decade, 10 million more than in

the 1970s. Respected researchers estimate that we will need between 2.1 and 2.5 million new housing units annually to accommodate these individuals and their families. Yet, as you are probably aware, housing starts in 1980 amounted to only 1.3 million units, and last month the annualized rate was even less.

Stimulating savings to meet the demand for greater housing capital must be a top national priority. The Administration's proposal for a generalized reduction in tax rates for individuals does not sufficiently focus, in our opinion, the incentives needed to boost personal savings and assure an adequate flow of capital for housing. To our knowledge, there is no historical experience to suggest that an unspecified, generalized rate cut would produce in the near-term the volume of savings needed by depository institutions to bring the housing industry out of the doldrums. We are concerned, too, by the signal a tax cut of the magnitude proposed sends to the already jittery money markets -- where T-bill rates reached new peaks a week ago. The markets continue to focus on the size of the budget deficit in making interest rate decisions.

To make sure that a substantial part of any tax reduction is saved, not spent, we applaud the willingness of this Committee to explore specific tax incentives for savings.

The interest exclusion bills introduced thus far expand upon the important beginning provided by the $200/$400 exclusion developed by your Committee in the 96th Congress. That pointed a new, though modest, direction -- reversing decades of bias in our tax laws toward consumption and against savings. Now is the time to make that breakthrough a permanent

fixture of our tax laws and expand upon its promise.

Similarly, a broadened opportunity to plan for one's retirement through deductible contributions to an Individual Retirement Account is increasingly important given the strains on our Social Security system.

Unquestionably, an expanded exclusion and an expanded IRA are immensely popular ideas. Some of you may have seen placards and ballots in the lobbies of savings and loan associations across America and the advertisements in national magazines in the past few months which ask customers: "Isn't it time to give a real tax break to savers?" The Savings and Loan Foundation tells us that they have received over two million replies -- in the affirmative -- to date.

We appreciate that the Committee is understandably concerned about the potential for revenue loss to the Treasury by these various proposals. We have long been convinced that the Treasury would gain far more than it would sacrifice as productivity is replenished and jobs created by increased personal savings. It is our understanding that an imporant "supply-side" analysis recently completed by the Joint Economic Committee staff confirms our view. The revenue foregone remains a consideration, however.

While all of the bills mentioned are meritorious, we would like to submit a new variation on the savings' incentives theme: a proposal which adds new dimensions to the tax-break-for-savers objective. An "All Savers Tax Act" could be structured to lower the cost of credit to borrowers and restore the vitality of depository institutions -- as well as promote savings.

Here is how it would work:

#- A special account is established of one year maturity.

#- Interest earned on theaccount is excludable from Federal income taxes to $1,000 for individuals, $2,000, joint returns.

#- The account is available from July 1, 1981 to June 30, 1982.

#- Depositors at commercial and savings banks, savings and loan associations and credit unions are eligible.

#- In recognition of the tax exclusion privilege, the rate of return at time of purchase is limited to 70% of the average yield on one-year T-bills.

#- The rate to new purchasers is adjusted periodically.

Let me explain the reasons behind the various features.

In recognition of the near-term concerns about revenue impact and budget deficits, the exclusion is carefully limited in amount ($1,000/$2,000) and duration (one year). Significantly, the revenue effect is distributed as taxes are paid in 1981, 1982 and 1983; very little would be foregone in 1981, for example, though the boost through supply-side effects would be underway and the chances for a return of thrift institutions to profitable, tax-paying (rather than refund-collecting) operations would be greatly improved.

Next, it is important for reasons of public visibility to have a new, special account. Unlike the general $200/$400 exclusion in force since January 1, where the incentive goes largely unnoticed until tax returns are filed, a special account can be marketed to the public.

With the rate of return indexed below market rates, you are attracting lower-cost, lendable funds into institutions. When the costs of attracting savings are 10% and 11% -- not 14% and 15% -- mortgage, consumer, small business and farm operating loans can be offered at affordable rates once again. Yet, the effective yield remains attractive to many potential savers because of the tax exclusion.

The one-year maturity has significance, too. It will secure the type of sound savings which truly contribute to capital formation -- not the "hot money" which will churn in investment uses of questionable long-term benefit to our economy.

Because of the interplay between the $1,000/$2,000 exclusion limit and the 70% of T-bill rate ceiling, we anticipate that such an account would be of greatest appeal to taxpayers in marginal tax brackets between 30% and 45%. We estimate that as much as $180 billion could be attracted in new savings to all depository institutions. The housing-specialized savings and loan business might see $80 billion in these special accounts -- funds which can be pumped out in mortgages at rates far more affordable to home buyers than the 17.12% quoted at the most recent FHLMC auction.

Important, too, is the stability such a proposal provides to our financial system. It gives depository institutions a competitive tool to meet the challenge from the unregulated money market mutual funds, without excalating operating costs. It could remove the much-publicized possibility of special Federal assistance to the ailing thrift industry.

Mr. Chairman and members of this Committee, we urge your careful consideration of this broad, yet focused, proposal to help savers, to help borrowers, to help depositories. When you confront the tax reduction issues later this year, we hope the "All Savers Tax Act" can help you meet that challenge.

* * *

On behalf of the U.S. League and its 4,400 member savings and loan associations nationwide, I have welcomed this opportunity to present our views. Again, you are to be commended for the leadership this Committee has taken in pursuing tax incentives for savings.

STATEMENT BY RALPH S. SAUL,
CHAIRMAN OF THE BOARD AND
CHIEF EXECUTIVE OFFICER OF THE INA CORPORATION,
BEFORE THE SENATE FINANCE COMMITTEE

May 19, 1981

Mr. Chairman and Members of the Committee:

My name is Ralph S. Saul. I am Chairman of the Board and Chief Executive Officer of the INA Corporation. I very much appreciate the opportunity to testify before this Committee in support of tax reduction legislation essential to reinvigorate our economy.

We address the issues before this Committee from the pragmatic perspective of almost 200 years in insurance and investment markets.

INA Corporation ("INA") is one of the nation's largest diversified financial services organizations and among its oldest commercial organizations. Our total assets are $10.6 billion. In 1980, INA's world-wide operations produced consolidated revenues of $5.25 billion, and after-tax income from operations of $293 million.

INA vigorously supports and endorses the President's Economic Recovery Program. Not only do we support linking

tax reductions to additional spending cuts, but we want to congratulate the Administration for its convincing leadership and unwaivering commitment to these principles. And we congratulate Congress for responding favorably to the President's bold initiatives.

We support these programs to control inflation and to produce capital for jobs, economic growth and an improved competitive position internationally.

As the Administration and this Congress have recognized, restoring our economic vitality depends upon reducing the federal deficit by curbing federal spending. As significant as recent actions taken by the Senate and the House to achieve these goals are, no long term success can be achieved without halting the uncontrollable drain of government entitlement programs. In the search for alternatives to reduce and replace federal entitlements, INA is committed to solutions that foster creative participation by private industry in meeting public needs that otherwise would be met through government largess.

We were privileged to appear before this Committee in March, 1979, to present our recommendations for greater

private participation in federal health care entitlement programs. Based on INA's experience, we expressed our concern that current federal health financing programs reward excessive spending, discourage cost-consciousness and prevent meaningful participation by the consumer. We appreciate this Committee's work and that of other members of Congress since then, in modifying federal health care programs through the application of market-oriented economics.

Today, I appear to suggest a private sector solution to meeting the retirement needs of the nation's workers. INA is concerned that the federal tax structure discourages self-reliance, thus needlessly increasing dependency on government entitlements and pressures on the federal budget.

In our business, we are particularly sensitive to the severe constraints on individual savings and retirement planning created by the burden of federal taxes, by the lack of incentives to save for retirement, and by the over-dependence on social security to meet retirement needs. We believe these interrelated problems call for comprehensive solutions.

The proposal that we bring to your attention today would address these interrelated issues and, in our

view, help achieve the President's economic objectives. Given the many and often difficult choices facing the Committee, we hope you will be interested in a concept that would provide tax relief, stimulate individual savings, promote capital formation, and strengthen social security through a new individually-based retirement option.

The Proposal

INA's proposal, which we call the Social Security Option Account, or SSOA, would allow individuals paying social security taxes to choose an alternative means of providing for their retirement. They would continue to pay social security taxes, but, in effect, trade future benefits for a present income tax deduction, which would enable them to establish their own retirement fund. The concept, simple in design, works as follows:

- Employees who pay social security taxes may establish a special retirement account and then deduct their annual contributions to this account from their taxable income.

- Tax deductions would be limited to 20 percent of their social security wages -- that is, the amount of earned income subject to social security taxes. Thus, the maximum individual deduction today would be about $6,000 each year, that is, 20 percent of the $29,700 social security wage ceiling.

- In return, individuals who set up SSOA's would forfeit a portion, a half percent, of their social security retirement benefits for each thousand dollars contributed to an SSOA. When individuals compare the amount of benefits given up to the permissible tax deductions, SSOA becomes an attractive alternative for a broad range of employees.

- The amounts deducted must be paid into an SSOA, a tax-free account similar to an Individual Retirement Account or Keogh Plan, administered by a qualified private fiduciary. The individual may draw on the account when he retires.

Thus, the SSOA proposal does not diminish revenues going into the social security trust fund, but does reduce

the total retirement benefits being paid out. By enabling people to rely on private pension sources, instead of social security payments, the SSOA program strengthens both the social security and private pension systems. By linking public and private retirement benefit programs, it offers more flexible planning opportunities for most working Americans. Finally, the SSOA program would create a significant tax incentive to encourage additional personal savings, a substantial portion of which would be channeled into new investment in the nation's economy.

INA, in consultation with actuarial experts, analyzed how the rate of forfeiture of social security benefits would influence individuals to select an SSOA. The worker's age, tax bracket, wage level, and expected return on investment would be factors in this decision. We also examined the economic effects of the SSOA plan on reduced social security outlays, general revenue losses, and capital formation.

Based on this initial analysis, we have concluded that:

- The SSOA plan would serve both the public goals of encouraging savings and stabilizing

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the social security system, as well as the private goals of security in retirement and flexibility in planning.

- Based on actuarial analysis, a forfeiture rate of one-half percent of social security retirement benefits for each thousand dollars of SSOA contribution would make the SSOA attractive to young and middle-age workers in a broad range of income levels.

- Preliminary estimates indicate that in ten years, the SSOA program would produce a capital pool of between $40 and $100 million in 1981 dollars; about one-third would be new capital.

- Preliminary estimates also indicate that by the year 2005, the SSOA program would reduce social security benefit payments annually by $10 to $25 billion in 1981 dollars.

- A one-half percent forfeiture rate would cost between $1 and $2.5 billion a year

in general revenues, although some of these losses would be offset by increased revenues stimulated by new investment. Thus, there would be substantial public benefits at relatively modest general revenue losses.

There are several methods to evaluate the impact of the SSOA. One straight-forward approach is to compare the impact of a $1.00 tax deduction contributed to an SSOA to that contributed to an IRA. Each additional post-retirement dollar of cost to the Treasury through participation in an SSOA will save the social security trust fund $2.50. Or, stated another way, on a dollar for dollar basis, the SSOA will produce a significantly greater benefit to the U.S. Treasury than the IRA program because of the future reductions in social security outlays even though a portion of SSOA benefits, unlike IRA benefits, would be tax deductible.

INA has prepared a "White Paper," describing the SSOA proposal in detail and providing preliminary estimates of its impact. It addresses the interrelated problems with which this Committee is concerned, and outlines how the SSOA plan would work. This "White Paper" will be available to the Committee and the staff.

Rationale

We prepared this report for several reasons. First, in our business, we have seen first-hand the severe consequences of our economic problems: low productivity, excessive taxation, inadequate opportunity and incentives for individual savings and retirement planning. These pressures threaten the ability of working men and women to maintain in retirement the quality of life of their working years.

Second, INA is disturbed by the disincentives, inherent in the current tax system, to save and plan. Tax deductible, retirement planning opportunities are limited to self-employed persons or to individuals without employer-based pension plans. And, the deductions allowed are small. This system fosters over-reliance on social security. While these benefits are an essential foundation for the nation's retirement programs, they should not be the sole source of retirement income. Such over-reliance adds greatly to the long-term fiscal deficit facing the social security trust fund.

Third, we believe a program such as SSOA will enable financial intermediaries like INA to sell retirement programs and, at the same time, provide capital for the nation's economy.

We also believe our proposal is both timely and relevant for your consideration. The Committee has before it tax reduction proposals that would stimulate additional savings and provide much needed tax incentives for capital formation. In our opinion, the SSOA proposal would be as effective as any before this Committee to stimulate the economy through increased savings. A significant portion of SSOA savings would be invested in new capital, rather than simply shifted from one form of savings to another. Secretary Regan indicated last Wednesday this effect would result from some other plans.

The Committee has considered proposals to expand tax incentives for individual retirement programs, providing greater flexibility and security in planning for some individuals (e.g., S. 12, S. 243, S. 518). Our proposal would expand the opportunity to participate in individual retirement programs to the vast majority of employees.

We all are mindful of the long-term financial deficit facing the social security old age and survivors trust fund. In 1945, each retiree receiving social security benefits was supported by about 15 workers; by the year 2000, each retiree will be supported by just two workers, creating a deficit anywhere from $600 billion to a trillion dollars.

Many proposals before this Committee address just one aspect of the problem -- tax relief, savings incentives, or social security solvency -- without taking into account the consequences of each proposal on the total problem. Increases in social security taxes, for example, have avoided trust fund deficits, but they also have diminished individual savings, deterred capital formation, and discouraged alternative retirement planning.

As individuals rely on rising social security benefits, they have little incentive to save for their own retirement needs. The tax system, too, discourages individual retirement planning. To meet the public's increasing dependence on social security payments, benefit levels and taxes must rise even higher, discouraging savings and

capital investment, restraining productivity, and reducing tax revenues. Thus, each problem aggravates the others.

The SSOA proposal would break this cycle. It provides a much needed vehicle for individual savings and retirement planning, which will bring substantial capital formation benefits, comparable or superior to other savings incentive proposals. Moreover, SSOA provides a bonus for the social security system. It would help restore its long-term financial viability without raising taxes, deferring the retirement age, or reducing benefit levels for those persons who depend on them primarily for their retirement needs.

Conclusion

We recognize that the SSOA is simply a proposal. However, we hope the Congress and the Administration will find it sufficiently attractive to initiate its own evaluation of the SSOA's long-term consequences and its overall public benefits and costs. We believe, as a tax reduction proposal, the SSOA program would be as effective as any idea pending before this Committee in channeling savings into new capital investment.

As Chairman Dole has stated, the country is ready for tax relief. Decisions will be made shortly on tax reduction legislation necessary to stimulate the economy. We leave to the Committee and Administration the appropriate time and legislative vehicle for Congressional consideration of our proposal.

The SSOA program would represent an important change of direction for federal policymakers. It would veer away from ever-increasing government entitlements, with their uncontrollable demand on the federal budget. Instead, it would help return the responsibility for retirement planning to the individual.

We very much appreciate the opportunity to introduce the SSOA concept at this hearing. We would welcome the continuing opportunity to work with Congress toward the realization of the important public policy objectives that it is intended to serve.

[The appendix to Mr. Ralph Saul's statement is in the official committee files.]

The CHAIRMAN. We appreciate it very much. Thank you for waiting most of the day to testify.

Our final panel will be Mr. Bushnell, Mr. Eckel, Mr. Curtis and Mr. Strickland.

STATEMENT OF NOLAN K. BUSHNELL, CHAIRMAN, ALLIANCE FOR AMERICAN INNOVATION

Mr. BUSHNELL. Mr. Chairman, my name is Nolan Bushnell, I am Chairman of the Alliance for American Innovation. It was interesting listening to the earlier speakers because it seems to me that their view is that the only way to improve productivity in America today is through increased investment. But there are actually two other very important, very necessary elements.

One of the earlier speakers said something to the effect that what are we should do to encourage worker productivity is increase our investment in the workplace.

That's not necessarily so. I agree that investment is very important. But investment in an obsolete factory isn't nearly as important as investment into new innovative, technologically superior plant.

Americans know that superior technology can put this country back together as much as increased investment can. And although I support tax cuts and capital formation in all forms, I think it is important that we also try to find ways to encourage incentive and innovation.

And that's why I support Senate Bill 889.

This bill will help the small businessman.

As I see it, the small businessman, has two basic problems. One is attracting good employees, and the second is attracting capital. I think these problems can be eliminated by encouraging investors to take risks in small businesses, and supporting increased employee stock ownership. Stock ownership is important because it gives the employees a vested interest. When they become partners they have an increased interest in their company's innovation and efficiency.

It is important to recognize that productivity is not just one great idea from the top, it is the consistent spirit of small decisions throughout the company.

These series of collective, innovative ideas from motivated employees can make America go forward again.

Under S. 889 an investor would receive a major cut in his capital gains tax if he were to invest in a company which is only 15 percent employee owned.

This is a small amount. Yet it would be enough, I believe, to bring forward much more venture capital investment in small businesses in America. It is the small businesseses—the small innovative businesses—that I am convinced will make the real differences in productivity in America today.

Thank you.

[Statement follows:]

OPENING REMARKS OF PAUL ECKEL, CHAIRMAN, CONTINENTAL EMPLOYEES' ASSOCIATION

Mr. ECKEL. Senator, my name is Paul Eckel and I am in the wrong chair I discover. I apologize for that.

It is a privilege and a great opportunity to have this moment to testify before this committee.

I think what I have to say as a result of my recent experiences with the Continental Employees'—I cite for your attention a full page ad out of the Washington Post recently where the Continental Employees are attempting to buy our airlines. You may know that we are in the midst of a hostile takeover attempt by Texas International Airlines.

I want you to know that our management and our employees are together in fighting off this attempt. The management initially tried to solve it all by themselves. They went to lenders, they went to other airlines asking for help. They came dry and they utterly failed.

They did not look to the employess as a resource, in fact we didn't look to ourselves. However, when we realized our company had failed and that if we were going to succeed, we must look to ourselves, and we came up with $110 million in just a couple of days, they began to respect us and include us, but I think this is a common mistake in America.

To not look to the employees or the workers of America for solution. I think we have made that mistake in our companies, and I think perhaps largely in Government, though perhaps not in this committee, I think there are two great problems that cry out for solution that we can be of help and that we need to be seeing a solution to.

One problem is capital formation and the second one is productivity. I learned recently of a bridge that was necessary to be built in Gary, Ind.

In Gary, there is a United Steel plant, but the place that they could get the steel that was of the highest quality and the lowest price including shipping was Japan.

We have to ask ourselves in America, why is this true. And it's because they are using 1930's technology and equipment in Gary, Ind., and they are using 1980's technology in Japan.

Again, I believe that is a problem related to capital. Productivity is related to capital investment. We need tomorrow's tools to solve tomorrow's problems. Not yesterday's tools to solve that problem, and I believe that because we as Americans have a lower savings rate of any major industrialized nation that what little capital there is available is awfully expensive, and perhaps part of that problem belongs to the Government.

I want to say that employees are a source of capital that is not being utilized in America today.

In Continental, our employees have taken out loans that total well over $185 million that we intend to inject 100 percent in our company to reduce its high cost debt and allow it to buy tomorrow's tools for tomorrow's problems.

The secondary to productivity, I wish I could communicate to you the excitement and the magic that is back in our airlines. I recommend that you ride our airlines from coast to coast, because we just

concluded a strike with our flight attendants, and the pilots crossed that line, and there was a great deal of bad blood, since the ESOP has come that friction has evaported. There is a feeling in the employees that we want to make this airlines a success.

We want to make our passengers happy and make them come back, because now we finally have a three-way partnership between the employees and the management and our shareholders and hopefully our passengers.

I submit to you that while a lot of the things you have discussed today, sir, in the committee are important and they do technically very good things for our country, this is one thing, the expanded ownership act of 1981 that can capture the imagination of America as it has done at Continental Airlines.

I bear you testimony that it has done that kind of thing at our company and I think it will do it for America.

Thank you for your time.

The CHAIRMAN. Mr. Curtis.

OPENING REMARKS OF JOHN E. CURTIS, JR., NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

Mr. CURTIS. Mr. Chairman, Senator Long, it is a sincere pleasure to appear today before this committee. Looking back at the past 10 years of ESOP-type legislation, I think that something very important is happening this year and it gives me and the National Center for Employee Ownership a great deal of pleasure.

The first ESOP bill that Senator Long introduced as an initial piece of legislation was in 1978. He was the only Senator responsible for that bill.

In 1979 he introduced an ESOP bill that had two sponsoring Senators, himself and Senator Gravel. In 1980, there were three, Senator Long, Senator Gravel, and Senator Stewart.

Senator Long's bill this year has 30 cosponsors. This means that 30 percent of the Senate that has finally begun to agree with Senator Long that employee ownership is very important in this country.

A representative of the Investment Co. Institute testified two panels ago and pointed out the fact that over the past decade the United States is tied with Great Britain for the lowest productivity gains of any lesser industrial nations.

An actual survey that was reported last year, indicated that from the decade 1967 to 1977, Japan's productivity gains were 107 percent, while we were tied with Great Britain at 27 percent. Clearly this is a problem that has to be resolved. Part of the solution to this national problem will come from capital formation and capital investment.

But the other part of it, increased employee productivity and motivation, is an equally essential requirement in rebuilding our productivity.

During that same period when our national productivity was declining in relation to that of other countries, surveys demonstrated that employee-owned companies continued to succeed. The Survey Research Center at the University of Michigan performed a study that was later reprinted in a Department of Labor report; this study indicated that employee-owned companies were 150 per-

cent more profitable than comparable nonemployee owned companies.

A study of worker-owned plywood companies in the Northwest, reflected that the individual output of those worker owned companies exceeded the industry standards by over 30 percent.

This committee, in 1979, conducted a survey of 72 employee-owned companies with ESOP's. Those companies had been in existence for over 24 years. The ESOP, at the time of this survey, had been in existence for 3 years.

Over that 3-year period, those 72 companies realized a 72-percent increase in sales, and an increase in sales per employee of 37 percent. They were 157 percent more profitable, and from the Treasury's point of view, they paid 150 percent more in Federal income taxes.

Grover Cleveland once said "labor is the capital of the working man." In 1850, that was certainly true, 94 percent of the U.S. industrial power was supplied by muscle from men and animal. Today, the industrial frontier is closed, most of our productivity comes from machinery, and yet very few individuals have the opportunity to own it.

A 1976 study by the Joint Economic Committee, under Senator Hubert Humphrey, found that more than 50 percent of this country's individually owned capital was owned by less than one-half of 1 percent of the population.

Clearly, this is time for what President Reagan described in 1975 as the Industrial Homestead Act.

I would summarize my remarks by saying that the National Center for Employee Ownership believes ownership works, it calls up a common purpose to succeed and it places the ability to effect the economic performance of a company in the hands of those that can truly share in it as they produce it, the employees.

Thank you.

The CHAIRMAN. Mr. Strickland.

[Statement follows:]

OPENING REMARKS OF ROBERT L. STRICKLAND, CHAIRMAN OF THE BOARD, LOWES CO., INC.

Mr. STRICKLAND. Thank you, Mr. Chairman. I am Robert Strickland, chairman of Lowes Cos. I am glad to be here today, and I think you are glad to see me as the last speaker in a very long day.

My purpose today is to strongly support S. 1162 and employee stock ownership by testifying to three important points.

First, employee stock ownership works and I have seen it work for over 20 years, a fact at Lowes, not a theory. It unites two powerful forces: economics and human nature.

Second, our country needs this bill, now more than ever.

Third, and probably most important, ESOP tax incentives based on our experience at Lowes are not a permanent Treasury tax drain but rather an investment for future revenue growth.

How do I know it works. Well, I submitted a long testimony summarizing Lowe's 20 years of substantial employee stock ownership.

My company has 6,000 employees in 215 locations in 19 States. Last year, Mr. Chairman, the sales per average Lowe's employee

were $150,000 each and the profits were $3,000 per employee. Those numbers are three times the average posted by the Nation's three big retailers, Sears, Penney's, and K-Mart.

I stated that now is the time for this bill, because as we begin to reindustrialize this country and make investment in plant and machinery, we must also revitalize the added use and the motivation of our work force.

The current Harvard Business Review asks is it possible that during the next 50 years that robots will replace our blue-collar workers, the way that tractors replaced horses and mules on the farm in the prior 50 years.

I am convinced that the way to revitalize the motivation of our workers is to give them a piece of the action through employee stock ownership so in the future we won't see magazines with robots on the cover.

What we will see is workers like warehousers at Lowes that retired, never made more than $125 a week while working, but he retired with a $400,000 nest egg thanks to employee stock ownership.

Senator Long's bill speaks for the fact that only about one-third of American workers are employed in manufacturing jobs, the other two-thirds are in services, communications, professions, labor intensive, not capital intensive businesses.

Sears Roebuck has more employees than either Exxon, General Electric or IBM and K-Mart has more employees than U.S. Steel.

Prior ESOP legislation aimed at the one-third of workers in the manufacturing jobs, and this bill aims at the two-thirds of workers in the labor intensive jobs.

So in the 1980's, where the economic environment seems to be telling us that we are going to be facing increased international competition, expensive and scarce capital and perhaps nagging and domestic unemployment, I am convinced that the keystone of our economic policy should be to strengthen those labor intensive industries.

Before Lowe's employees owned stock, our average tax paid per employee, per year was $1,900. Following the acquisition of its stock by employees that jumped to $2,200. Last year, in fact for the last 3 years the average corporate tax paid has grown to $3,600 per employee per year. Almost a double of the old rates.

I have a summary here of impact in chart 9 of what might happen if the 1-percent payroll tax credit is adopted and if dividend deductibility is adopted. It seems to me that what it shows is that during year 3, there will be a net incremental revenue to the Treasury.

I have those samples there. So, this is supply side at work. I strongly support S. 1162 and I thank this committee for your leadership in this employee stock ownership movement.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Strickland, you're saying that if we provide a tax advantage for forming employee stock ownership plans where you permit funding as a percent of payroll—let's say start with one percent of payroll—so that we can provide for companies like J. C. Penney and Sears the same type of incentive that we now have for Exxon, American Telephone, all these private investor-owned com-

panies—which are very enthusiastic about it today, by the way—it wouldn't cost the Government any net revenue because you have more productivity, companies could do a better job and make more money, and the Government would actually make a profit out of it? And that is your experience in your company?

Mr. STRICKLAND. That is our experience, Senator and these are my assumptions. I talk about the 1-percent tax credit and the dividend deductibility accounting for 70 new jobs per year. During year 3, I show $1.9 million in tax incentives by your bill to Loew's and $2 million in added tax generated. The spread gets greater in subsequent years.

Senator LONG. Now an ESOP company pays less taxes in some respects. I would like to ask Mr. Curtis, who once worked for this committee, how do you wind up paying more taxes to the Government even though in some respects you pay less taxes?

Mr. CURTIS. Senator, you accomplish this in several ways.

First of all, if one believes that employee ownership increases productivity and profitability, the corporations are certainly going to pay more in corporate income taxes as a result of this increased profitability after the tax incentives than they did before.

Also to use a phrase from the last administration, the feedback of such a tax incentive is going to put more people to work as a result of the increased profitability growth of these corporations, and those people are also going to pay taxes.

I think it is pretty clear that the feedback from creating incentives for employee stock ownership would be higher than the tax incentives that are created at the outset.

Senator LONG. Well, I want to call one other witness who couldn't be here, but I hope he is with us in heart. I believe he is and with his help I think we will succeed.

I just want to quote a couple of things from this witness. "Capitalism hasn't used the best tool of all in its struggle against socialism—and that's capitalism itself. Roughly 94 percent of the people in capitalist America make their living from wages or salaries. Only 6 percent are true capitalists in the sense of deriving their income from ownership of the means of production."

More than 100 years ago, Abraham Lincoln signed the Homestead Act making it possible for our people to own land. This was a revolutionary development. Ownership of land in most of the world had not been possible for the ordinary citizen. Generally, land belonged to the king or emperor and through him to the favored aristocracy.

The Homestead Act set a pattern for American capitalism. Today, 53 million Americans own their own homes. Now, we need an Industrial Homestead Act, and that isn't impossible. As a matter of fact, any number of companies and corporations in America have tried a variety of ways to spread ownership among their employees.

I'll ask that the rest of this statement appear in the record. That is from Ronald Reagan.

The CHAIRMAN. Is that a recent statement?

Senator LONG. That is February, 1975. In the last campaign, he talked about it. So, we have an excellent witness. All you have to do is bring him up to date with the present situation—a little

nudge and I guess we will really be off with something that is of more interest to rank and file America.

Now, you saw a lot of nice people in this committee room. Those people are among the 6 percent that Ronald Reagan is talking about who own a lot of equity capital.

But, as far as the other 94 percent, the kind of thing you are talking about is, in my judgment, more interesting to them than in this business of 10-5-3.

In the long run this will not cost the Government anything. As a matter of fact, this is one way you might hold down the cost of social security.

When people own a substantial estate, themselves, then they don't need to rely upon a Government pension as much.

One of the problems of this Government is that for most folks their primary asset is their entitlements under social security—which is just a promise to tax their children to take care of them.

Mr. BUSHNELL. I backed into employee ownership almost accidentally, I felt that my company was growing so fast we really didn't have the opportunity to install rigorous management methods. The only way we could get everything going in the same direction was to get everyone on the same team.

It worked like a charm and that is the point I would like to make. It worked. It increased productivity because no one was giving anyone else a free ride.

We were all pulling together. I remember one instance in which a fellow in my company even eliminated his own department with an innovative idea. It wasn't a big department—10 people, but he came up with an idea that eliminated his job and the jobs of 10 people. He wouldn't have done that if he didn't have an ownership stake.

Of course we put those people into other sections in the plant. But it is still very hard for me to think of someone who just punched a clock coming up with that kind of plan.

Senator LONG. He probably said don't let the boss man find out about this.

Mr. BUSHNELL. Right. You really can't defeat the incentive that makes this country work. It has worked.

The CHAIRMAN. How many Continental employees are there, Mr. Eckel?

Mr. ECKEL. There are 11,000, sir.

The CHAIRMAN. How many own stock?

Mr. ECKEL. In our company right now I would say there are fewer than 500 who own stock. But, we did this different then everybody else.

The CHAIRMAN. Not more than 500 then raised $185 million?

Mr. ECKEL. No. We are talking about before ESOP. I thought you wanted to know how many were stockowners before. Now, we are talking about people who have elected to give up 15 percent of their pay and if you looked at Chrysler——

The CHAIRMAN. But, how many are there now?

Mr. ECKEL. Well, all 11,000 will if we are successful.

The CHAIRMAN. What is the average value, average stock value?

Mr. ECKEL. You should understand we are fighting off a hostile takeover and our ESOP is ready to go but we have to win a fight in

court. As soon as that fight in court takes place then we will pull down 15.4 million shares of our airline at an average price of probably $11 to $12 or about $185 million worth. Then we will begin to repay that loan and as we repay it the shares will be allocated from an unallocated area to each individual employees' account, so that we might someday find ourselves in the same spot as Bob Strickland's fellow who retired——

The CHAIRMAN. I think one problem may be not with Continental, but in many of these airlines and the auto industry, is labor costs. The reason the Japanese complain about quota legislation floating around here for awhile, is that they don't understand why the autoworker is still making $19 an hour. We are trying to protect that group of people.

Then this may not be specifically related, but it seems to be one advantage of ESOP would be to help some of the labor disputes if you take an interest in your company. It might reduce adsenteeism which is a big, big problem and strikes which are also a big problem, as you have indicated. That has great potential. I am not certain whether you can clearly tell. Maybe lows come from highs, but maybe you don't have organized labor to contend with.

Labor costs are very high in the airline industry. Pilots make a great deal of money; I wonder if they deserve it for 3 days a week.

Mr. ECKEL. Let me suggest two things that you have called to my mind, sir. One is that our pilots recognize that we have to be more competitive. That is what has happened to American industry in general. We are rapidly becoming second rate in steel, automobiles and probably in airlines if we don't get on the ball.

So, what we are talking about, our goal in the committee we have established with the company is to increase flying hours at Continental by 20 percent without adding one pilot or $1 to that payroll. That is our goal and we are going to do it. I am absolutely convinced of that. We have already found ways to do that. It is a matter now of selling it.

The second thing that is very significant. This $185 million we are funding into our company—right now the new technology and equipment is not immediately available off the line—we are going to reduce our $213 million in long-term debt down to $28 million which will save almost $70 million a year of cash flow to the company, $35 million of interest expense and the other $35 million is going to retire principal.

So, it is a phenomenal benefit to our company. We showed a $21 million loss last year; had we had the ESOP we would have shown approximately a $20 million profit.

Mr. CURTIS. Mr. Chairman, if you think back to the Chrysler situation in which Congress provided Chrysler with $1.5 billion in loan guarantees and the employees had to agree to wage cuts or give up fringe benefits, one of the things that the Congress required was that the employees acquire stock ownership through an ESOP.

That was the first time that the employees had ever given up a wage or fringe benefit to get stock ownership, and yet they only agreed to do it because Congress required it.

Since that time I am sorry Senator Grassley isn't here. The Rath Packing Co. in Waterloo, Iowa, became the first company to ever

set up an ESOP in which the employees agreed to reduce their wages to buy stock. It is a much smaller situation than Continental, but at Rath since the establishment of the ESOP as of January 1, they have had the highest productivity per employee in the history of the company. This is a company that is 80 to 100 years old.

The Rath employees agreed to give up current pay to get the deferred benefit of ownership. Continental's ESOP could dwarf that in size.

In Continental's case the amount of stock ownership will average between $10,000 and $15,000 per employee at today's market price.

If you consider what the employees are doing for Continental in terms of paying back $185 million in debt instead of Continental doing it, I think it is very likely that the price of Continental stock should go up dramatically and instead of having $10 to $15,000 in stock per employee's stock, it should be a multiple of that.

Senator LONG. I would like to ask Mr. Eckel just one more thing. Would you just give us a few indications.

First, let me say, what you are doing reduces cost and it's anti-inflationary because a company reduces its expenses by virtue of the fact that these workers will take less pay in order to own some stock. Isn't that right?

Mr. ECKEL. That is correct.

Senator LONG. All right, that is one good way to make the company more effective.

Would you mind telling us to the extent that you can, just in short order, how from the pilot on down different people are thinking of ways that they can be more effective in making this airline a better airline and also a more profitable airline?

Mr. ECKEL. What has really been exciting is—almost more than anything else—is the attitude, the willingness to look for these ways, but the effect that it has had on our passengers. The employees now, rather than treating a person as a passenger, they are like a guest. Someone that you desired greatly comes back. They are being treated that way.

These significant efforts to discover new ways and I am most familiar, of course, with the pilots. We have gone to our reserve pilots and pilots make a lot of money and they sometimes have second jobs just to kind of stay interested. Those days are past. We are looking for ways to make our No. 1 job our only job and it is going to take enough time to do that, but we are going to put America back on its feet from our standpoint.

The only contribution we can make is in our jobs and we intend to, for example, fly our reserves who have historically flown like 25 hours a month, up in the neighborhood of 60 hours a month. We can do that. We know ways to do that. We can weed out little nonproductive things such as we go on reserve at noon and off the next day at noon, but most of your flights leave at 7 in the morning. You call a reserve, he only has 4 hours of duty left so he is wasted. You pick a guy who is coming on duty.

There are so many little things that have crept into the work rules over the years that we can, because of the innovation Mr. Strickland refers to or Mr. Bushnell. I am sorry. Those kinds of

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innovations are coming back and it is the employees who are thinking of them; not the company.

It is a tremendous thing to be involved in.

I would also like to say that this little bit of the pie at Continental has been going into discharging debt. That debt is gone and we are taking out of this part of the pie that was going to salary, taking part of that without increasing the amount going to salaries and that is what is going to pay on the debt to ESOP.

So, in fact, we have replaced debt with no expense at all for our company which we are excited about because finally, now, as I said, we got a three-way partnership. All of—the employees, the management, and the stockholders all have the same goal. We all got on the same side of the ball and it is an exciting thing to be in.

Senator LONG. Can a pilot figure out a way to make that plane use less fuel?

Mr. ECKEL. You bet we can and we are doing that. In fact, it is astounding the ideas that are coming out, like not on a 727 with three engines, not starting the third engine until you are out to the runway. Starting that then which will save maybe 200 pounds of fuel, not much, but if you did that on 500 flights a day at Continental Airlines you are talking about a savings of over $15 million a year in petroleum—just that one little idea. It came from an employee.

Senator LONG. Well, how about the people who load the baggage?

Mr. ECKEL. I can't attest to that fact, but I am sure that they are. I think that they want to beat you to the street with it now.

Senator LONG. Well, who was that comedian on television awhile back?

Alan King, I believe, and he said the moral of this is give that bag to the gorilla, don't give it to that porter.

If your airline would not only give better baggage service, but would take better care of the bags——

Mr. ECKEL. Better baggage service is a big objective. We did have one lady who said to us, "If you can fly this airplane 600 miles an hour in the dark and find Los Angeles, you can find my bags."

Senator LONG. Well, let me just say one more thing. I am not here to accuse anybody. I have many times suspected that when you get on one of these flights and the pilot just doesn't take off and just doesn't take off—you just can't get up because the hostess can't let you get out of the seat and the hostess sometimes—not feeling very good—will keep that seat belt sign on or the pilot keeps the seat belt sign on so, that being the case, you don't get any service.

I am not saying that is just the way it happened; I just suspected it happened.

Mr. ECKEL. That would never happen on an employee-owned airline.

Senator LONG. That wouldn't happen on an employee-owned airline because you would want the passenger to come back, wouldn't you?

Mr. STRICKLAND. May I make one comment in response to a question the chairman asked?

Senator LONG. Yes, sir.

Mr. STRICKLAND. About hard numbers and about cost savings. One of the problems in the retailing industry is pilferage and inventory shrinkage. It is not uncommon for some companies to report a 3 percent of sales to 4 percent of sales in inventory shrink or pilferage.

Now, in a $1 billion company, that is $40 million per year. If you believe in the concept of tax expenditures, that pilferage at the end is a tax expenditure of $20 million using a 50-percent rate to round up.

Compared to that 3 to 4 percent industry average, Mr. Chairman, at Lowes we budget one-half of 1 percent for inventory shrinkage.

During the last 20 years, our employees have never owned less than 18 percent of stock of our company. Today, we own about 25 percent in total.

I am confident that is one reason for that low inventory shrink. There is absolute revenue impact that doesn't get measured in the normal channel.

Mr. BUSHNELL. I can back up that story—inventory shrinkage.

That part, that 3-percent part of the 4,000 which it does, is inflation because that produced item is not going to be in productive use.

When you find engineers going back into your obsolete inventory and designing worthless items, that is inefficiency. If that is stuff that has been thrown away, that is inflation.

So, productivity and efficiency is really the converse of inflation and that is really what we are talking about.

Senator LONG. I would like to ask that a statement by Ed Sanders and a statement on behalf of the President—be made a part of the record.

Would you put that statement of Ronald Reagan in? Incidentally, I asked if it would be all right at the White House and they said by all means.

[Statement on page 720.]

Mr. CURTIS. Mr. Chairman, as part of my written testimony I also have attached written statements of two other people, Mr. Ron Ludwig of the ESOP Association of America and a statement of a representative of the Kelso Companies. I would ask that they also be included.

The CHAIRMAN. They will be made a part of the record.

[Material on pages 729, 734.]

Mr. ECKEL. May we put this editorial from the Denver Post, called the A Proud Bird's Challenge, outlining the situation at Continental and its effect on productivity in the record?

The CHAIRMAN. All right.

[Material is on page 717.]

The CHAIRMAN. Service on Continental has always been good. Is it better than it was?

Mr. ECKEL. Much better.

Senator LONG. Let me congratulate you. You have had a good day here. You have had a good group of witnesses and I think they added a lot to this Committee's knowledge of what we are trying to do here.

The CHAIRMAN. I want to express my appreciation to Senator Long and also this panel being here since—you have been here

probably since early morning. We appreciate your forbearance and your excellent testimony.

I think the President would be willing to do business with Senator Long if Senator Long would do business with the President. He has a prospect.

Thank you.

[The prepared statement of the preceding panel follows:]

Statement of Nolan K. Bushnell

Chairman, Alliance for American Innovation

Before the Senate Committee on Finance

May 19, 1981

Mr. Chairman, my name is Nolan Bushnell. I am Chairman of the Alliance for American Innovation, an organization dedicated to promoting policies and legislation that will help individuals build new businesses employing innovative ideas.

I am an inventor and businessman. I founded Atari, Inc., based on my conception of the video game. I am currently Chairman of Pizza Time Theatre, Inc., a chain of family dining centers with games and entertainment by computer controlled robot characters. And I have begun a number of other new ventures.

My own experience as an innovative entrepreneur has shown me that it is very difficult for individuals who have new ideas but no record of business success to start their own companies. Sometimes the very newness or genius of an idea makes it hard to sell even to risk capitalists. The irony is that it can be easier to get the seed money for a new bookstore than to find investors for a new concept around which a new industry could be built.

The innovative entrepreneur has two major problems. One, as I have said, is obtaining investment capital. The other is attracting highly skilled, reliable production personnel. Although there is currently a greater availability of risk capital - particularly for entrepreneurs who have a record of prior success and who are involved in high technology ventures - it would be wrong to conclude that there is an adequate long term supply. I believe the current greater availability of risk capital will prove to be a transient phenomenon. There continues to be a need to reduce capital gains taxes in such a way as to stimulate new ventures.

It is for this reason that we strongly advocate further capital gains tax reduction both of a general and a targeted nature. Such reductions could be accomplished either in the first, or in a second tax bill, but I believe they are important in order to create an adequate supply of investment in American industry.

We therefore support S.75, sponsored by Senators Wallop and Moynihan, and S.145, sponsored by Senator Moynihan. Both would reduce capital gains taxes measurably by increasing the exclusion for individuals and reducing the corporate tax rate. We also support a reduction in the maximum tax on investment income from 70 percent under present law to 50 percent. The effect would be to equalize the tax treatment of earned income and "unearned" or investment income.

In addition to these generalized capital gains tax cuts we also believe it is necessary to implement a targeted capital gains cut that would help the innovative startup company obtain investment capital and skilled employees.

Such a bill, the American Innovation and Employee Stock Ownership Act of 1981, has been introduced by Senators Long, Roth, Bentsen, and Wallop. S.889 would increase the deduction for individuals to 80 percent leaving 20 percent to be taxed as ordinary income. For corporations, the alternative tax would be reduced from 28 percent to 14 percent. To qualify for this special capital gains treatment, the investment must be in a small company that has shared a portion of its stock ownership with its employees. In addition, the corporation must have fulfilled a basic R&D expenditure requirement.

To be considered "small", a company must have at least two of the following characteristics:

Total gross revenues of not more than $30 million;

Net worth of not more than $15 million;

Not more than 1,000 employees.

To qualify under the employee ownership criterion, 25 percent or more of the non-management employees of the business must own an amount of shares equal to at least 15 percent of the total outstanding shares of the company. We define non-management personnel as all employees other than officers and members of the Board of Directors of the Company. This provision ensures that lower level managerial and support staff as well as hourly employees can benefit.

Under the bill employee ownership can be achieved in a number of ways. An employee stock ownership trust is an obvious method; but stock could also be distributed by giving shares as bonuses, selling stock to employees at concessional prices, or through stock options.

To fulfill the research and development criterion, the corporation must have expended an average of 2.5 percent of its gross revenue on research and development for the three prior taxable years, or for the taxable year during which it has been operating if the corporation is less than three years old.

Mr. Chairman, we believe that this bill is important because it will both provide a new incentive for risk capital investment in new businesses, and increase employee participation in ownership of the companies for which they work. My experience is that employee ownership is an important element in a new firm's success. Increased productivity is not the result of one manager's effort - it is the result of the creative dedication of teams of people throughout a new

company. An ownership stake can create such dedication and high performance at the most critical stages of a new company's existence.

I have had personal experiences with employee ownership through an ESOP and I favor their use, though I would stress that S.889 does not require use of ESOPs as a means of achieving stock distribution to employees. At Atari I chose to establish an ESOP because of my commitment to the idea that it is good, in and of itself, for people to own a part of the enterprise for which they work.

Atari's ESOP was particularly effective. As a new company experiencing tremendously fast growth we didn't have time to install strict procedures to assure accountability and operations control. Our ESOP helped create a greater sense of responsibility and thus less waste and theft. One supervisor struck on an innovation that eliminated his 10-man department, an event which I believe would not have occurred had that individual not owned a piece of the company.

When we sold Atari it was necessary to liquidate the ESOP. Its shares were bought at the highest price paid for any class of stock, for a total value of $1.3 million. The liquidation resulted in some considerable individual benefits. An 18 year old women who took a pay cut when she came to work for Atari because of the availability of stock ownership, realized enough to buy her first home.

One change that I would recommend be made in current law would be to amend the Internal Revenue Code to permit the use of ESOPs by Subchapter-S corporations. I understand that Senator Long's S.1162, the Expanded Ownership Act of 1981, would make this change.

Mr. Chairman, S.889 has three important characteristics.

First, we believe that, because of the sequence of the development of new companies, the bill would result in a positive flow of funds to the Treasury.

When an investor or group of investors takes a position in a company, they do so with the expectation that they will not be able to sell a portion of their shares in the company for at least four to six years. During this period, of course, the company has hired personnel, spent for plant and equipment and research and development, and undertaken other activities that generate tax revenues.

This activity must of course, take place before any of the original investers can sell their shares at a profit, realize capital gains and take advantage of the special tax treatment, provided in S.889. In the interim, a sequence of new economic activity will have taken place which would generate additional taxes. A static analysis of the bill undertaken by the Joint Tax Committee indicates that the bill could cost between $125-$175 million.

Second, S.889 would stimulate employee ownership in a new way. Creating an ESOP is often too expensive and too legally rigorous a task for a new startup company. Yet it is at this early stage of a new company's existence that employee ownership is most useful for the company, and most beneficial for the employees. As I have mentioned, the company benefits at this early stage because of the increased motivation and dedication of employees who share ownership. The employees benefit from early stock ownership because it is often during the early years of a company's life that the greatest stock appreciation occurs. By creating an incentive for share distribution to employees at an early stage, S.889 would help both new companies and their employees.

Third, S.889 approaches the goal of employee stock ownership in a new way. To date, the ESOP has been the focus of efforts to encourage employee ownership. This proposal, however, provides an incentive for investors and management to

share stock ownership in any number of ways including ESOPs. It takes the burden off the ESOP as the primary mode of stimulating employee ownership, and it creates an incentive for the original investors in a new enterprise to bear the initial costs of sharing stock ownership.

Mr. Chairman, it has been amply demonstrated that most major innovations have stemmed from small companies - that new, smaller companies formed to exploit an innovative new product or process are a key to our nation's economic vitality.

A report on research and innovation prepared as part of the Joint Economic Committee's special study on economic change reported that

> "small firms (with less than 1,000 employees) were responsible for almost one-half of the most significant new industrial products and processes during the period of 1952-73."

The importance of the smaller corporation is underscored by a 1977 report of the Office of Management and Budget which concludes that "while companies with fewer than 1,000 employees received only 8 percent of the Federal R&D dollar, those companies were responsible for about 50 percent of the major technological innovations over a 20-year period."

We submit that a reduction in capital gains taxes as proposed in S.75 and S.145, combined with a targeted cut as proposed in S.889, would dramatically improve the climate for innovative entrepreneurship.

I believe, Mr. Chairman, that with this tax bill this Committee and this Congress can make history. The bill can mark the turning point from an economy dominated by the old economic giants to one dominated by the industries on which our collective national future will depend. We suggest, therefore, that in

shaping the bill the Committee consider inclusion of at least three other changes that would stimulate innovative American industry. First, the Committee should consider including a tax credit for incremental spending on corporate research and development. The need to strengthen private sector R&D is demonstrated by the challenge to our high technology industries by foreign suppliers. U.S. R&D spending peaked in the 60's at about 3 percent of GNP. It has since declined at the same time that R&D spending by our major competition has increased.

An R&D tax credit under which a non-refundable income tax credit would be allowed for research expenditures to the extent they exceed the average of such expenditures over a base period of three years would be very useful. The credit would be equal to 25 percent of the incremental research expenditure.

As a companion to this proposal we believe it important to provide a tax credit for corporate contributions to U.S. university research. Universities have performed about one half of the total basic research in the United States, and are particularly important in generic research, which private companies often have little incentive to undertake. A 25 percent tax credit to encourage corporations to fund university research would be helpful. Governor Brown of California has just proposed an expanded program of basic research for the University of California, including establishment of a matching program through which the State government would match corporate contributions for university research projects. Such a Federal tax credit could help direct university research programs towards the needs of industry and away from the needs of the government agencies that are now the main source of grants. And it could increase the supply of technical graduates.

Finally, there is a need to recognize that success in innovative enterprise, as in all forms of endeavor, should be rewarded, and that the availability or promise of reward is an extremely important stimulant to success. In the past, stock options were a useful means for rewarding successful endeavors, but that usefulness was curtailed by the 1976 tax changes which altered the restricted option. Qualified stock options should be re-instated. They would greatly expand the incentives necessary to attract able executives and managers to new, high-tech ventures. They would make available again an important incentive to and reward for success.

For the longer term, Mr. Chairman, I believe we must put double taxation of dividends high on our list of reforms.

We all know that dividend income is taxed twice, and that no other form of income arising through corporations is similarly double-taxed. No other major country fails to give relief to part or all of the double tax.

Unfortunately, this clearly needed reform has been inhibited by quarrels about who should get the tax relief, and by the cost in lost revenues to the Treasury.

We believe that relief from double taxation should occur at the stockholder, rather than the corporate, level because that is where the double taxation in fact occurs. And to mitigate the revenue loss we propose that relief be given by permitting individuals to establish dividend rollover accounts.

We propose that any individual should be able to establish a special account at any bank, brokerage, trust company, or other appropriate financial institution through which he could reinvest his cash dividends in the stock of qualifying corporations, without payment of the dividend, or "double" tax.

This is essentially a plan for deferring tax on dividends until the investor decides to remove all or any portion of his dividends or shares from his "dividend rollover account", at which point they would be taxed. There are two exceptions. The first is that the owner of the account may withdraw his dividends without paying tax when he or she reaches the age of 59½. Thus the program would promote the goal of providing adequate retirement income security for older Americans. The second is that the individual would be able to withdraw his dividends tax free in case of total disability, as now defined in the provisions of the code having to do with individual retirement accounts. This provision is also consistent with broader social objectives.

In order to target investment to smaller, more innovative companies, investors would have to invest in qualifying companies. Qualifying companies would be those that can be considered small and can fulfill a basic R&D expenditure requirement. To be considered small, companies would have to meet the same criteria used in S.889.

The R&D requirement would be met if the company spent an average of 2.5 percent or more of its gross revenues on research and development expenditures for the 3 prior taxable years, as provided in S.889.

This program would have several positive results. First, it would permit individual investors to make decisions about the use of their capital unfettered by the additional or "double" tax on their dividends. It would promote retention of earnings in productive investments, making speculative investments in real estate and tax shelters less attractive. It would in short strengthen the equity markets.

Second, it would inhibit the trend to conglomerization in American industry. Because stockholders typically do not seek dividends (many investors see the dividend tax as prohibitive), corporations in turn have no incentive to distribute earnings to shareholders. Instead, they accumulate large pools of cash which they often choose to spend not on internal innovation but on the acquisition of new companies, in this way seeking to continue an apparent pattern of corporate growth. One effect of the proposal would be that corporations would feel a new pressure to distribute earnings to shareholders, who then have the ability to reinvest them in promising, smaller companies.

Third, the dividend rollover account would encourage the accumulation of individual savings in investment accounts, and these savings would be available tax-free at retirement.

I stress, Mr. Chairman, that we are proposing this idea for discussion. We do not suggest that it be included in the bill currently under consideration.

Conclusion

This country faces an enormous task of revitalization in which the creation of a highly innovative economic climate is a critical objective. This means shaping incentives which encourage individuals and enterprises to take high risks in new ventures, to exploit new, perhaps hardly dreamed-of technologies that will be the "basic industries" of the future.

To achieve this new climate, government must take a consistently less interventionist role in American economic life. It must create the conditions for stable economic growth. It must end its obsession with preserving the troubled sunset industries. It must focus on the future, on encouraging the tremendous potential that new technologies now hold. We all must heartily embrace a growth policy that stresses innovation and encourages its exploitation by entrepreneurs.

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TESTIMONY PRESENTED TO THE

UNITED STATES SENATE COMMITTEE ON FINANCE

May 19, 1981

PAUL R. ECKEL

Chairman, Continental Employees' Association

The Airline Pride Built (and Bought)

Mr. Chairman, and other Members of the Senate Committee on Finance, it is a privilege to appear before you today to discuss the ESOP which we have proposed for Continental Airlines. 205 years ago, a determined group of Americans fought a revolution and won the right to elect their own government, to own property and build their own individual security. They started the great American dream which became a reality for many. The Homestead Act broadened this opportunity when we were a rural and agrarian society.

With the advent of the Industrial Revolution and need for substantial capital, the corporation became the owner of land and other property and the employer became the "owner" of most people. Stock in those corporations provided security for the future. Technology became more complex and mass production of goods and services brought prices down to the level where the average person could live in relative comfort and our free market capitalism allowed us to quickly become the leader of the free world.

Unfortunately, the average American didn't, and still doesn't, own much stock in American industry.

Our desire to export our system and our concern for human rights caused us to help our former enemies of World War II rebuild their economies, using our model. Germany and Japan are now two of our closest allies.

However, while we were exporting our "know how" we were not paying attention to our problems. In effect, we were creating new enemies among our own people. American workers were growing apart from management as companies became large and impersonal. Unions became the enemy of many companies with employees having to choose sides -- their company or their peers, who argued that "in union there is strength". Labor unrest and demand for more and more pay for less and less work increased prices for American products and services. Our exports dwindled and imports increased. Unemployment again became a major problem. Government concern for our own unemployed, and for those who didn't have the foresight or ability to save money, created the need for expensive welfare programs to take care of those who couldn't take care of themselves.

Since it is not popular to tax working people to support those who aren't working, and without a major war to use as the reason for "belt tightening," the United States has witnessed a steady stream of deficit spending, pushing our currency into a long decline to its present depreciated value. Hard assets became the thing to accumulate -- land, minerals and rare gems. To accumulate paper money in large amounts was seen as being only for very foolish people.

Unfortunately, corporations still need money to meet payrolls, buy equipment and finance growth. They began to have increasing difficulty raising equity capital as their earnings and dividends were reduced by escalating costs and increased interest rates which results from inflation and the competition of government's deficit financing. The public began to shift remaining savings to high-interest, short-term bonds and the stock market prices fell even lower. The "smart money" decided that many companies were worth more "dead than alive."

Our 11,000 employees at Continental Airlines decided that we wouldn't roll over and play dead for a "smart money" man who came after us. We believe our company is worth much more "alive" than it is "dead". We petitioned our management to allow us to become bidders for control of the company. Eighty five percent of our 11,000 employees voted and of those who voted, 96% said that they would be willing to give up 15% of future gross income to finance 185 million dollars of new equity for our company. We've designed an ESOP to borrow this money and made Continental Airlines capable of funding the ESOP from the amount saved by the reductions in future employee compensation. Thus, our employees will get equity positions in exchange for the monies given up from their future salaries.

We've started our own quiet and peaceful "revolution" and a group of bankers have over-committed on our loan requests. Our union leaders know that we can't resort to strikes in the future to settle our differences with management. If the management makes money for the stockholders, they'll be making money for us as well. We'll be motivated to do those things that will result in dividends and growth in the value of our stocks. If we have to lower our pay or work longer hours for the same pay to make our company successful -- we'll do it! Our pilots are already in discussion with management about ways to increase the average time flown by pilots by 20% with no increase in pilots or payroll -- this is how to increase productivity and pay for it in equity to give us future financial independence.

We've been sued by Texas International ("TI") and called "management tools" as if we were mindless chattels who can be manipulated at the will of the company. This is ridiculous!

If TI was to attempt to replace its fleet of airplanes today, it would only cost $9 million more than the present depreciated value of that equipment. If Continental were to do the same thing, it would cost us $536 million more than the present depreciated value of our fleet. Our airplanes, not our company, are the true target of Texas International!

The TI attack normally would be laughable if it was not financed with over $200 million of loans which can only be paid

off through dismembering our company. Even worse, TI is using its Continental stock as security for its raid on our company and our fleet. After TI "takes over", *if* that occurs, TI will repay much of its debt by selling our airplanes!

We are committed to a fight for our rights, and we feel almost as strongly about these rights as another small group felt in 1776. The courts will have to decide whether we have the right to own part of the company we've built, and whether we can have real equity to substitute for the "sweat equity" we've invested.

When we're successful many other companies will be able to use our "three-way partnership" approach to doing business as a model. We want to be in partnership with our management and they want it also. Our public shareholders will have their property in good hands with us, as we will then have the same interests they have -- higher dividends, greater growth and profitability. Broadened ownership of American industry will result in lower consumer prices and lower taxes due to lower welfare cost. This will result from having more people at work, as our products and services become more competitive and as the quality increases.

Senators Long, Laxalt, Matsunaga and others have been of tremendous help to us. I'm hopeful that the rest of this important group of American leaders will see merit in our efforts as well. Our kind of plan will create large amounts of new capital for our capital-starved industries and bring management and labor together so they can learn to work together and jointly solve their problems. When we add the capital incentive of stock growth, we should really get our airline moving in the right direction. As other companies and industries follow our lead, this will necessarily have a major benefit on our American economy. An ESOP provides a very unique "supply side" motivation, as corporate dollars go directly into capital formation rather than consumer goods or speculation. This capital, and motivated people, will bring prices down and reduce our dependence on the government by keeping our own people working, both for their company and themselves.

Thank you.

A proud bird's challenge

EMPLOYEES AT Continental Airlines, trying to head off a takeover attempt from Texas International Airlines, may also have shown us a way to revitalize the American economy.

Texas International went on the open market to buy 48.5 percent of the "Proud Bird." But a newly formed Continental Employees Association would buy enough additional stock, authorized under the corporation's by-laws, to block the takeover. In addition, sale of the new stock would provide the company with an infusion of capital. The employees' plan is doubly impressive.

First, it shows the *elan* of the Continental Employees, 2,200 of whom are based in Denver, that they would rally behind their employer in such spirited fashion and pledge so much of their personal economic future to safeguard their jobs.

But secondly, their plan hints at how America can attack the root cause of its economic woes, sagging productivity.

It's a myth, and a dumb one at that, that the productivity of U.S. workers is falling because they no longer want to work hard. Most Americans still take pride in honest labor.

Anyway, productivity has very little to do with how *hard* a worker works, at least in the sense of physical effort. What counts is how *well* he or she works. That, in turn, depends upon education, job training and the quantity and quality of workers' tools.

In the broad sense, productivity depends on *capital*, a term that includes both machinery and acquired human skills. Foundering American productivity is mostly due to sagging business investment. It's that investment which provides new machinery, new research and new technologies to drive a dynamic economy.

The government can stimulate such investment by "supply side" tax policies. But personal savings are the key to investment, and Americans save only about 5 percent of their income — about a fourth of what the Japanese save and the lowest figure of any industrialized nation. To revitalize the American economy, we need to spend less now on consumer goods and more on capital goods. Which brings us back to Continental.

Federal law encourages companies to form tax-exempt employee stock ownership plans. The Continental employees have given that idea an extra twist. They're offering to divert $185 million in future pay raises from their pockets to stock purchases, and to work harder and longer. With that pledge as collateral, they'd seek to borrow the money now to buy the necessary stock.

The key is their offer to invest part of their scheduled wage increases in stock in their company. That keeps that money at work in the company. Unlike proposals to just slash wages, such a scheme doesn't penalize workers. Instead, it gives them a direct stake in the welfare of their company, safeguards their jobs and insures them a larger share in the fruits of their labor.

The employees association expects it will take about two weeks to see if the rank and file at Continental goes along with this plan. We hope they do — but in any case we would like to see labor unions and managements across the country develop similar employee stock plans. Taking part of future wage hikes in stock would help break the inflationary spiral which is making cash less valuable.

The Continental workers' plan shows not only pride, but brains as well.

TELEPHONE 751-5800

THE ESOP ROLLOVER PROVISION

(More revenue for the IRS?)

The Expanded Ownership Act of 1981 contains a tax free rollover provision. Briefly, it would allow for a tax free rollover of the proceeds of a sale of small business stock to an ESOP or TRASOP. If proceeds are reinvested within eighteen months in other small business stock, gain would not be recognized for tax purposes until a subsequent sale is made. This discussion will attempt to illustrate some of the consequences of such a provision and to suggest that the Internal Revenue Service consider carefully what the net result would be.

As an example consider two cases: One in which a man dies at age 65 and his estate pays the normal death taxes. The other case in which a man at the age of 50 decides to use the proposed Rollover Provision to sell his stock over a fifteen year period to an ESOP Trust and then also dies at age 65. In each case the men die at the same age and presumably pay the same estate taxes. In the first case a small business may be destroyed in the attempt to pay estate taxes. Employees may be thrown out of work. The Treasury suffers the loss of future corporate tax on what was a going business as well as employee income tax. Also lost is the 6.65% employee and 6.65% employer contribution to Social Security. In addition, there are unemployment compensation costs attributable to those who do not find employment immediately. In the second case if a proposed Rollover Provision were in effect, a prudent man could plan his retirement years in advance. At retirement age he would own little, if any, stock in the original small business. His income would now continue to come from other investments which he had made by rolling his stock over. At his death the IRS would receive the same revenue as if he had stayed in his original business. Since the original business is still in operation, all normal taxes from this source would continue. There is even a further gain to the Internal Revenue Service if consideration is made of the increased corporate and personal income generated by this man's rollover investments during this fifteen year period. In addition to all this, his rollover investments would tend to be more liquid and thus facilitate his final estate settlement.

The example just cited oversimplifies conditions in the real world. There may be more than one stockholder involved. The time span may be longer or shorter. The conditions differ with almost any conceivable corporation. The one condition that does not change, however, is the fact that a transfer of ownership must take place sooner or later and this transfer, unless accomplished in an orderly manner, is harmful to the economic health of small corporations. The ownership of small corporations under present tax regulations is frozen into a state of suspended animation. Management tends to remain in the same hands

as long as possible and when age, desire or death forces a change, the employees are usually unable to afford the cost of "buying their own jobs" to continue the enterprise.

It appears that a Rollover Provision would be particularly suited to a small ESOP corporation for several reasons. The ESOP trust now acts as a market for stock. This market already is regulated by law to protect ESOP participants. The sale of stock to an ESOP trust is a simple process. Unlike a large corporation with publicly traded stock, the small ESOP corporation has more need for a system to encourage continuity. In an ESOP corporation this continuity could be accomplished in an evolutionary manner which would keep pace with the normal work life span of the average employee. In a non ESOP corporation, there is little incentive for a major stockholder to transfer his capital ownership unless it is through a tax free merger or liquidation. In an ESOP corporation there is some incentive because of capital gains treatment on stock sales to the ESOP trust. In an ESOP corporation with a Rollover Provision there is every reason to take a long term position and begin the transfer of ownership which must inevitably take place. That such a transfer of ownership accrues to present employees is a step in the direction of broadened capital ownership. And Congress has already "made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system." (see Section 803(h) of the Tax Reform Act of 1976)

The ESOP Rollover Provision is not only for holders of stock outside the ESOP trust. At present any employee of an ESOP corporation, upon termination of his employment for any reason, may receive his vested portion of the ESOP trust and roll it over tax free into an Individual Retirement Account. The Rollover Provision under discussion is simply a further development of this idea. An individual would be able to receive his vested interest and purchase stock in another small business corporation or conceivably invest it in a business venture of his own. Such an action emphasizes the fact that ESOPs represent individual ownership of capital and are not meant to be risk free. Any venture in capital formation may fail or succeed, but it seems like a good idea to leave that choice and chance up to the individual.

The cost of an ESOP Rollover Provision occurs because of a tax deferral. No tax reduction is involved. After this initial time-cost of money has elapsed, no change in revenue occurs. Tax revenue then continues at the same pace. Against this initial delay in tax revenue must be weighed the perpetual health and continuity of small enterprises on one hand and the effect of mergers, inheritance taxes, liquidation or any other change in ownership that takes place eventually without an ESOP Rollover. The corporate use of ESOPs is a fairly new development. The total number of ESOP corporations is small compared to the total number of corporations. Therefore, any tax legislation concerning ESOPs will have a small effect caused by deferred revenue. If the idea of an ESOP Rollover is sound, now is the time to consider it.

RONALD REAGAN URGES EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP") FINANCING

February 1975

VIEWPOINT with Ronald Reagan

"Tax Plan No. 1"

Capitalism hasn't used the best tool of all in its struggle against Socialism — and that's capitalism itself.

Roughly 94% of the people in capitalist America make their living from wages or salaries. Only 6% are true capitalists in the sense of deriving their income from ownership of the means of production.

Both groups enjoy the highest standard of living the world has ever known; certainly far better than anything socialism has produced for its people. We can win the argument once and for all by simply making more of our people capitalists.

More than 100 years ago, Abe Lincoln signed the Homestead Act making it possible for our people to own land. This was a revolutionary development. Ownership of land in most of the world had not been possible for the ordinary citizen. Generally, land belonged to the King or Emporer and thru him to the favored aristocracy.

The Homestead Act set the pattern for American capitalism. Today, 53 million Americans own their own homes. Now we need an industrial Homestead Act, and that isn't impossible. As a matter of fact, any number of companies and corporations in America have tried in a variety of ways to spread ownership to their employees.

In San Francisco, a man named Louis Kelso has evolved a plan which a number of corporations have already implemented. Now when a corporation needs to expand, it finances the expansion either by borrowing or by selling new stock issue. Under the Kelso plan, an employee trust is formed. A company desiring new capital sells a new stock issue to this employee trust. The trust, in turn, borrows the money from a bank or lending unit, using the stock as collateral. Each individual employee winds up owning stock in the company directly proportionate to his salary or wage level and he has a vested interest in the company's ability to prosper and to increase earnings.

Over the next 10 years, there will probably be $500 billion worth of new investment for businesses and industrial expansion. It can also be $500 billion worth of corporate ownership by employees. An ever-increasing number of citizens thus would have two sources of income — a pay check and share of the profits. Could there be a better answer to the stupidity of Karl Marx than millions of workers individually sharing in the ownership of the means of production?

Some years ago, an executive of the Ford Motor Company was showing the late Walter Reuther (head of the auto workers union) through the Ford assembly plant in Cleveland, Ohio. Pointing to the latest in automated machinery he said, "Walter, you'll have a hard time collecting dues from those machines." Walter said, "You'll have a harder time selling them automobiles."

The obvious answer neither of them thought of was that owners of machines can buy automobiles.

Tomorrow I'll tell you of another plan — one that would give every registered voter in America an active share of ownership in the industry of America.

It's possible to have that and the plan I've just described. All it takes is a bill by Congress.

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TESTIMONY PRESENTED TO THE

UNITED STATES SENATE COMMITTEE ON FINANCE

May 19, 1981

JOHN E. CURTIS, JR.
Kilpatrick & Cody
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TESTIMONY TO THE SENATE COMMITTEE ON FINANCE

BY JOHN E. CURTIS, JR., OF WASHINGTON, D.C.

May 19, 1981

Mr. Chairman and distinguished Members of the Senate Committee on Finance, it is a sincere pleasure and privilege for me to appear today to testify before this Committee. Among the various issues which this Congress will consider as part of President Reagan's proposed tax package, and similar proposals from Senators and Congressmen, is the issue of expanding employee ownership in American corporations. This issue is of critical importance to the continued reindustrialization of American industry. The National Center for Employee Ownership believes that broadened ownership among our working American men and women will go hand-in-hand with the capital formation proposals which form the cornerstone of President Reagan's economic recovery program.

This past week, Senator Long introduced S.1162, the Expanded Ownership Act of 1981. The National Center for Employee Ownership believes that Senator Long's floor statement, delivered in connection with the introduction of this Bill, should be suggested reading for every newly-elected Senator, Congressman, and every economics and civics student in our high schools and colleges. Senator Long's statement pulls together into a single document a comprehensive and compelling explanation of our National needs for broadened ownership, capital formation, increased productivity and economic opportunity, and technological innovation and reindustrialization.

We heartily endorse Senator Long's beliefs on issues related to broadened ownership and we appreciate the tremendous efforts he has made to give the American worker an opportunity to acquire a true "piece of the action." This, we believe, is what President Reagan meant in February of 1975 when he stated that "The Homestead Act set the pattern for American capitalism. Today, 53 million Americans own their own homes. Now we need an industrial Homestead Act, and that isn't impossible. As a matter of fact, any number of companies and corporations in America have tried in a variety of ways to spread ownership to their employees." We are also delighted to note that other Senators and Congressmen have begun to support Senator Long in his

efforts. During the past Congress, numerous pieces of legislation were introduced, and passed, to promote the broadening of stock ownership among employees. Several weeks ago, Congressman Ed Jenkins introduced legislation (H.R. 3085) to help accomplish this goal. The National Center for Employee Ownership strongly supports Congressman Jenkins' proposed legislation and would urge this Committee to give serious consideration to that Bill at the same time it favorably reports Senator Long's Bill.

When one speaks of an ESOP, the type of plan which usually comes to mind is the "leveraged" ESOP, which borrows money from a bank or other lender to purchase employer stock. In most cases, the extension of credit to the ESOP is guaranteed by the employer. Using the proceeds of the loan, the ESOP purchases employer stock either from the employer or from outside shareholders, thereafter holding the stock in trust for the benefit of participating employees. Each year, the employer is committed to making a contribution to the ESOP equal in amount to the ESOP's annual amortization of this indebtedness. Because the employer's contribution to the ESOP is treated as a contribution to a "qualified" benefit plan, the entire contribution is tax deductible to the employer. In effect, the leveraged ESOP permits an employer to borrow money, or generate additional capital, through the ESOP, repaying any indebtedness incurred with tax deductible dollars. The only limitations on the ability of an employer to utilize the ESOP in the way in which Congress clearly intended it to be used (as reflected in its description of the ESOP in the Tax Reform Act of 1976 as a "bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees") are the arbitrary limitations imposed by the Internal Revenue Code.

In creating the concept of "qualified" employee benefit plans, the Congress intended to promote the establishment of retirement plans by employers for their employees. As an incentive for the employer to adopt these plans, the Congress provided that employer contributions to such plans are tax-deductible to the employer. However, to prevent the use of these plans purely as a mechanism to channel benefits solely for officers, shareholders, and highly compensated individuals, or to prevent the use of these plans purely as a means of avoiding corporate income tax, the Congress imposed dollar and "percentage of compensation" limitations on the amount of the tax deduction available to an employer for contributions to these plans in any given year and imposed similar limitations on the amount of benefits which may flow to any individual employee in any given year. While these limitations may well have a valid application for the normal employee benefit plan, they act as a tremendous barrier to

the ability of employees to acquire significant amounts of stock in their employers.

To resolve these problems, Senator Long's bill increases the amount of tax deduction available to an employer for contributions to an ESOP to permit the ESOP to repay indebtedness incurred as part of a leveraged acquisition of employer stock from 15% of the total compensation of participating employees to 25% of that compensation. It also provides partial relief from the arbitrary limitations imposed on the amount of allocated benefits to any ESOP participant's accounts. Congressman Jenkins' bill has provisions very similar to those contained in Senator Long's bill, although, since its purpose is to promote situations in which employees acquire "all or substantially all" of the total outstanding stock of the employer through an ESOP, Congressman Jenkins' relief provisions only apply to such a situation. Irrespective of whether these relief provisions apply only to a situation in which employees acquire "all or substantially all" of the outstanding stock of their employer or whether they apply to any situation in which the employees acquire stock in their employer through a leveraged ESOP transaction, the National Center for Employee Ownership believes that these proposed changes are essential if Congress is to continue to promote employee ownership in any meaningful way.

In addition, recognizing that if an ESOP owns all, or substantially all of a corporation's stock, it may be desirable to assure that stock ownership be limited solely to those individuals who are active employees of the corporation and best able to impact on its profitability through their increased motivation and productivity, both Senator Long and Congressman Jenkins propose that, in such a case, a former participant's benefit can be distributed to him solely in cash. This also assures that there will always be sufficient stock in the ESOP to provide ownership opportunities to newly hired employees. The National Center for Employee Ownership believes that this proposal is consistent with the whole concept of employee ownership and makes a great deal of sense. We strongly support it.

To further encourage employers to provide the benefits of stock ownership to their employees through ESOPs, Senator Long's proposed legislation would also make the following changes in the Internal Revenue Code, all of which are endorsed and supported by the National Center for Employee Ownership:

1. To provide employees with a continuing awareness of the benefits which accrue to them because of their stock ownership, much like that traditionally received by stockholders in publicly-traded companies, it proposes to provide a corporate dividend deduction for dividends paid on employer stock in an ESOP and

passed through currently to (and taxable to) participating employees. In addition, it would provide that such dividend income to participating employees is eligible for the dividend exclusion provided by Internal Revenue Code Section 116.

2. It permits an ESOP to be treated as a charitable organization for income, gift and estate tax purposes provided that the stock which is allocated to participants' accounts under the ESOP does not accrue to the benefit of the donor, his or her family members, or shareholders who own more than 25% of the outstanding stock in the employer.

3. Recognizing that in the traditional business transaction, an existing shareholder may engage in a tax-free transaction under which stock in his company is transferred to another, presumably larger corporation, creating no tax liability for the selling shareholder, it proposes to put the ESOP in the same attractive category for that shareholder by providing that if he sells his stock to an ESOP, or to a worker-owned cooperative, he will be able to roll the proceeds from the sale tax free into another investment, provided that the entire amount is reinvested in another small business within 18 months.

4. To correct an anomaly in the law, it increases the deduction limits (from 15% to 25% of covered payroll) for employers which maintain both an ESOP or stock bonus plan and a profit sharing plan, provided the additional 10% deduction is invested solely in employer stock. The 25% ceiling is permissible if an ESOP is combined with a money purchase plan or if a profit sharing plan is combined with a money purchase plan; this provides the same treatment for a combination ESOP and profit sharing plan as for any other combination of plans.

5. To redress a currently unworkable situation, and one which could potentially create an open ended liability on an employer's balance sheet, it revises the rules regarding the ability of the employee to "put" (that is require the repurchase of) his stock by the ESOP or the employer to a 60 day period following the date of distribution to him, and if the put option is not exercised within that 60 day period, to a 60 day period at the beginning of the next plan year. The existing put option rules are too open-ended, unnecessarily impacting on the employer's financial statements and providing a meaningless option to the employee who generally knows within a very short period following distribution whether he wishes to resell his stock to the ESOP or to the employer.

6. In recognition of the fact that there are tax and investment advantages which arise from the use of subchapter S corporations, it permits an ESOP to acquire stock in a subchapter

S corporation without removing the tax benefits which accrue to such a corporation. Absent such a provision, employees would continue to be unable to acquire stock in a subchapter S corporation.

7. In many situations, corporate financial planning and stock recapitalizations make it desireable that certain shareholders invest in nonvoting stock of the employer. The current provisions of the Internal Revenue Code prevent the ESOP from acquiring that nonvoting stock, despite the fact that the stock had significant value to the shareholder and should have a corresponding value to the ESOP. In effect, this precluded those shareholders from ever selling their stock to an ESOP. To redress this problem, it would permit an ESOP to acquire such nonvoting stock; however, to avoid a situation in which the nonvoting stock was being used purely to deny voting rights to participating employees, it would limit the ability to sell nonvoting stock to an ESOP to situations in which the shares of stock acquired by the ESOP had been outstanding for at least 2 years.

8. It removes from the computations of the employer's ESOP contribution deduction and allocations of employer contributions to participating employee accounts under the ESOP all interest on the ESOP's indebtedness and any forfeitures which occur from terminated employees.

9. It provides that an ESOP may assume the estate tax liability for the value of employer stock transferred to an ESOP by the executor of an estate, provided the sponsor company guarantees payment of the tax and agrees to pay the tax over a period of years. This provision parallels Code Sections 6166 and 6166A (relating to the extension of time for the payment of estate tax where an estate consists largely of an interest in a closely-held business).

In 1975, Congress created the Tax Credit Employee Stock Ownership Plan (TRASOP). The TRASOP provides an employer with an additional 1%, or 1½%, investment tax credit above the normal 10% investment tax credit for which all employers are eligible. However, this additional investment tax credit is available only in situations in which the employer establishes the TRASOP and contributes to the TRASOP an amount of stock equal to the additional investment tax credit claimed. It is estimated that between 400 and 500 employers have established TRASOPs since 1975 as a result of this legislation. However, the provisions of the Internal Revenue Code relating to TRASOPs are presently scheduled to expire at the end of 1983. Recognizing that significant benefits have accrued to millions of employees as a result of these TRASOP provisions, and realizing that employers incurred a great

deal of expense in establishing these plans, Senator Long's legislation would make the following changes in the Internal Revenue Code regarding TRASOPs:

1. It would make the TRASOP, and the additional investment tax credit, a permanent part of the Internal Revenue Code.

2. To encourage labor-intensive employers (whose capital investment has been insufficient to warrant the tremendous expenditure of establishing a TRASOP) to provide stock ownership for employees, it would provide an alternative tax credit for the employer, based on wages and salaries paid to employees, provided that a corresponding amount of stock was contributed to a TRASOP.

In creating the TRASOP concept, the Congress determined that it would be desirable for employees to remain as shareholders through the TRASOP for a period of time in order that they recognize the benefits which accrue to them as a result of their stock ownership. Accordingly, Congress provided that benefits from a TRASOP should not be distributable to participants for a period of 84 months following the date on which the stock is contributed to the TRASOP. In accordance with traditional rules involving qualified employee benefit plans, the Congress provided exceptions to this 84 month rule in the event of a participant's death, retirement, or termination of employment with the sponsoring employer. However, in establishing these rules the Congress failed to recognize that the very employers which have established TRASOPs, that is the largest corporations in the United States, are those which undergo a continuing series of acquisitions and divestitures of subsidiaries, divisions, and division units. No exception was created in the TRASOP rules for such a situation. This is a serious oversight in that the employer, absent a specific exception to that 84 month rule, must continue to maintain a TRASOP which holds stock for employees who have long since departed and become employees of another corporation. Under ERISA, the sponsoring employer is required to keep a current address for those employees and ultimately distribute the benefits to them. However, in light of the fact that no employer-employee relationship exists following the sale of the subsidiary, division, or division unit, it is completely impossible to trace those employees. On the other hand, for the employer to distribute those benefits to the former employees prior to the expiration of the 84 month rule triggers a recapture of the investment tax credit, and a significant loss to the employer. This is a problem which needs resolution if the TRASOP concept is to continue to grow. To redress it, Senator Long's Bill and Congressman Jenkins' Bill would provide that in the event of the sale of a subsidiary, a division, or a unit of a division to another employer, and the transfer of the employees to the direct or indirect employment of that employer, the 84

month limitation would not apply, and each participant's TRASOP benefit could be distributed to him at that time, provided, however, that the acquiring corporation did not also maintain a TRASOP.

I would like to include with my testimony, the statements of Mr. Dickson C. Buxton, President of Private Capital Corporation (the Kelsó Companies) and Ronald L. Ludwig, Esquire, Chairman of the ESOP Association of America's Legal Advisory Committee. These gentlemen, and their organizations, have been strong advocates of employee stock ownership. Since they were unable to be here today, they asked me to submit their statements for them.

The National Center for Employee Ownership continues to be a strong supporter of ESOPs, both as a method of corporate finance and, more importantly, as a method of building stock ownership into employees. We wholeheartedly endorse the provisions in the bills introduced by Senator Long and Congressman Jenkins, and we would encourage the 97th Congress and President Reagan's administration to adopt these provisions and give our working men and women a continuing share in the reindustrialization of America. Thank you very much.

STATEMENT OF

Mr. Dickson C. Buxton, President
Private Capital Corporation
(The Kelso Companies)

TO

THE UNITED STATES SENATE
COMMITTEE ON FINANCE

May 19, 1981

Mr. Chairman, and Members of This Committee:

The "Advocacy Task Force on Small Business Continuity", which was established by the Carter Administration has stated that the retention of ownership of small companies by their own employees is socially desirable from not only the standpoint of the employees themselves, but also from the community and from the nation at large.

The section of Senator Long's Bill (S.1162), dealing with the ESOP Estate Tax Credit would not reduce revenue, but rather would shift responsibility for payment of estate taxes attributable to certain closely-held business interests to an Employee Stock Ownership Plan, with the sponsoring corporation guaranteeing the tax.

The concept is simple: The IRS would collect estate tax on qualifying business interests from those who can keep the business viable -- the employees who have been given the opportunity of ownership by the estate of a decedent stockholder. Under current law, the estate can defer taxes over a 10- or 15-year period, but normally has little control over business profits during that tax deferral period. We think the ESOP trustee is a better creditor for the IRS.

For purposes of understanding this proposal, consider the following hypothetical situation:

"ESOP ESTATE TAX TAX CREDIT BILL"

Situation:

Privately held company operated by the founder for his family. The fair market value of the stock not a major consideration — income comes from salary, bonus, etc. Employees get income the same way — they are not concerned about value of the stock, ownership or control. Eventually, stock value becomes of great importance to the founder, his heirs and the employees.

Problem:

When the large shareholder dies, an executor will assume control of the business for the eventual benefit of the heirs. Employees will now be concerned with this important element of control and ownership. A management group will probably try to put together some kind of offer, very quickly, but they will normally lack cash and time. The executor will probably want to sell very quickly unless he takes advantage of the 6166* estate tax spreading provisions. If he does, the estate will have to be left open until the tax is paid and all estate assets will be collateral for the 6166 loan or a formal lien on properties of adequate value consented to by all persons having interest in the estate will have to be arranged for in accordance with the statute. The executor can't get any money out of the company (except through dividends or Section 303 redemptions) with which to pay the estate tax. Creditors of the company will wonder how this tax is going to be paid and, in view of the IRS lien, credit will start drying up for the company very quickly. This will cause great uncertainty and nervousness among senior management people — and this will quickly spread through the entire company. The executor who initially elects the 6166 estate tax spread in the absence of a formal lien and his discharge from personal liability, will become very nervous about his fiduciary responsibilities if business starts to fall off and he starts to assess his own liabilities. The first reasonable offer will probably be accepted by the

* See Page 5 for 6166 rule

executor and the company will become a division of a larger company. It might also be liquidated by some opportunist who buys assets of greater value than the forced sale price for the business.

Even if the Executor runs the company for the benefit of the heirs, the heirs will be concerned about their security and have very little control over the profit being generated by management and employees who will feel like "short timers". The heirs also have to wonder about where they are going to get income unless they are on salary.

As a result, the executor will be under great pressure from heirs and creditors to try to sell the company as soon as possible. A sale will trigger a total payment of the tax and the estate tax spread advantage will be lost. Also, the interest is high on the estate tax liability and can, in effect, double or triple the tax.

If the owner of the business had secured enough life insurance in his younger years to handle the full estate tax, the matter would have been resolved — and liquidity would have been established. However, a combination of inflation and alternative uses of money has probably caused the owner to minimum deposit his insurance reducing the death benefit and probably increasing the estate to much, much more than had initially been estimated. Life insurance is never sufficient to solve the majority of estate problems.

As a consequence, most people in their early 60's start looking around for buyers for their companies so that they do not leave their estates exposed. If the trend continues, medium sized private companies will continue to disappear and concentration of ownership will continue as the larger companies gobble up the medium sized and smaller companies. The perpetuation of the private company is jeopardized because of the estate tax ballooned by the inflation created increases in size of the estates.

The Employee Stock Ownership Plan is a partial solution to the problem — but liquidity for the ESOP trustee is also necessary if he is to buy stock from the estate in order to provide cash to pay taxes. Also, the establishment of a proper ESOP is an expensive project and many estate owners do not want to establish the ESOP and quickly increase the value of their common shares through a fundamental fair market value appraisal which would justify the sale of their shares during life at the appropriate price. They'd rather let their executors and attorneys fight to lower the taxable value of

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their common shares. Many ESOP negotiations have failed due to this one problem. The owner is not willing to sell his privately held shares for less than fair market value — but if he sells a small amount of his stock today, he establishes a price in the future that will increase his estate tax substantially. Therefore, he sits and suffers with a non-liquid position. It is a "Catch-22" situation.

If he sells the company, his employees will then work for a larger company (the lucky ones) and a lot of older people elect early retirement and start receiving social security income — (some of them have to go on welfare). A lot of lower income people will be out of work due to relocation of plant facilities and closures due to liquidation by opportunists. The Treasury loses a taxpayer in the event of liquidation and a large company can sometimes pick up new depreciation on asset purchases which further reduces Treasury income on certain kinds of sales. It is a "lose-lose-lose" situation as the heirs can no longer run a family business which has been created by the founder with loving care. If we could find a solution which would not cost the Treasury any money, protect the creditors of the company, the employees and management group and leave control of the company in the hands of the family and employees, it would be a good thing for small business!

Solution:

A new bill which would permit the executor of the estate to transfer to an Employee Stock Ownership Plan an amount of stock equal to that part of the estate tax created through ownership of business assets. The IRS to make the 6166 estate tax spreading provisions available to the ESOP trustee if the company guarantees principle and interest of the loan. The estate would have to qualify under the present 6166 rules. If the ESOP had been established and if transactions had occurred prior to the death of the stockholder, there would be a track record and evaluation would not be a problem. Otherwise, there would have to be a very extensive evaluation which would clearly establish fair market value of the closely held stock.

The heirs would inherit the rest of the stock and, under the committee system of voting, they would operate the company as before. Buy/sell arrangements with management personnel could assure that management would have partial control of the company and, thus, stay with the company to assure that the estate tax bill is paid.

As deductible contributions to the ESOP are made by the corporation, the IRS would receive tax and interest payments and stock would be allocated to the accounts of all employees, (management and others) to assure that "golden handcuffs" are provided to keep the people working to build the company. Employees would be motivated to increase productivity, profitability and pay off the estate tax as quickly as possible so that the stock could be allocated to their accounts.

Present management might decide to insure certain key men to assure continued cash flow to make contributions. However, the premium cost to insure younger key people who generate profits is much lower than insurance on the older shareholders for their lifetime to pay estate taxes.

Conclusion:

When the major shareholder dies, the executor is relieved of his tax liability and quickly closes the estate so that the company can continue to operate without interruption. The creditors will deal with a viable business with the same management and all of the employees more closely tied in than ever. There is the probability of an even greater profit to repay whatever debt has been incurred. The heirs of the founder or major stockholder are assured of a viable business enterprise — and all of the employees will benefit through this spreading of the capital base.

The IRS is better protected under a 15-year spread of estate tax than if the estate had the responsibility. The majority of the estate assets would normally be the stock in the privately held company — and the future of that company would be uncertain under any kind of protracted absentee ownership and management of the company. The IRS would now be looking to a viable business enterprise to pay the bill! Workers would b there to work off the debt rather than some nervous widow wondering how long everyone is going to stay around and pay off her estate tax bill.

It is important to shift responsibility for payment of the estate tax on business assets from the estate to the business — if the founder of the company is willing to have his employees become partners in his company rather than sell out to a conglomerate or liquidator.

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STATEMENT PRESENTED TO THE

U.S. SENATE COMMITTEE ON FINANCE

May 19, 1981

RONALD L. LUDWIG
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SUMMARY OF RECOMMENDATIONS TO SENATE COMMITTEE ON FINANCE

1. Encourage 100% employee ownership of companies by modifying present limitations on ESOP contributions.
2. Approve other special provisions applicable to ESOPs which own all, or substantially all, of the stock of the employer.
3. Modify TRASOP provisions to eliminate 84-month rule in the case of a sale of a subsidiary or division.
4. Make permanent the additional investment tax credits available for TRASOP contributions.
5. Allow alternative 1% of payroll tax credit for TRASOP contributions.
6. Allow deduction for dividends on ESOP stock which are "passed-through" to employees.
7. Allow charitable deduction treatment for donations of stock to an ESOP by a shareholder.
8. Allow for an ESOP to assume the liability for estate taxes when employer stock of equal value is transferred to the ESOP by an estate.
9. Allow employer a tax deduction for making the "matching" TRASOP contribution for employees.
10. Allow for the purchase of nonvoting common stock from a shareholder by a leveraged ESOP.
11. Exclude contributions applied to interest payments on an ESOP loan from the present deduction and allocation limits.
12. Delete Code Section 401(a)(22), which requires a limited pass-through of voting rights to ESOP participants.
13. Allow for tax-free "rollover" of proceeds of sale of stock to ESOP into other small business stock.

Ronald L. Ludwig
May 19, 1981

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STATEMENT TO SENATE COMMITTEE ON FINANCE

May 19, 1981

RONALD L. LUDWIG
Chairman, Legal Advisory Committee
The ESOP Association of America

Mr. Chairman, it is a sincere pleasure for me to present this statement to the Committee in favor of legislation which, if attached to any major tax legislation which is enacted this year, could have a significant impact on the growth and development of Employee Stock Ownership Plans in the United States. I am a practicing lawyer in San Francisco and also serve as the Chairman of the Legal Advisory Committee of The ESOP Association of America. The Association is a non-profit organization of companies which have adopted some form of employee stock ownership plan, including ESOPs and TRASOPs, for the benefit of their employees. We sincerely appreciate the past efforts which the members of this Committee have made to broaden stock ownership among employees.

Members of The ESOP Association of America, like all American businessmen, are very concerned about our declining National productivity. Clearly, something must be done to reverse a trend which has resulted in the United States having the lowest productivity gains of any industrial country in the western world during the decade 1967-1977 and which has given American business a negative productivity growth during the last two years. As we understand it, many of the tax proposals for tax cut legislation will be aimed at increasing our capital investment, capital formation, and productivity.

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Not quite one year ago, when the Congress last had the opportunity to consider major tax reduction legislation, it was my privilege to testify before this Committee, as well as the House Ways and Means Committee. My testimony then was in connection with H.R. 7848 (introduced by Congressman Jenkins) and S. 2953 (introduced by Senator Talmadge). On April 7, 1981, Congressman Jenkins introduced H.R. 3085, containing provisions similar to last year's H.R. 7848. On May 12, 1981, Senator Long (along with 30 co-sponsors) introduced S. 1162, a bill titled the Expanded Ownership Act of 1981, which among other provisions, addresses the important changes proposed by Congressman Jenkins' bill, as needed to expand Employee Stock Ownership Plans.

Studies have indicated that, when employees become owners in a company, their commitment to make the company succeed increases dramatically. For example, a study done among the plywood companies in the northwestern part of the United States reflected that employee-owned plywood companies had significantly greater productivity and profitability then nonemployee-owned plywood companies. In addition, the Survey Research Center of the University of Michigan found that employee-owned companies are 150% more profitable than their nonemployee-owned counterparts. Finally, during the last Congress, this Committee itself conducted a survey among companies which have established ESOPs for their employees. That survey, which was answered by 72 such companies, produced results which we believe are significant. For example, these companies indicated that in the average three-year period following the establishment of the ESOP, as compared to an average twenty-four year pre-ESOP corporate existence, they experienced a 72% increase in sales per employee, had a 158% increase in corporate pre-tax profits, and paid 150% more in Federal income taxes.

If there has been a weakness in the development of ESOPs, it has been that in too many situations the employees do not own a sufficient amount of stock in their company to really appreciate the benefits of ownership. The Survey Research Center concluded that the motivational and productivity impact such a program has upon employees varies directly with the percentage of ownership they have in their company. What we are proposing is that this Committee and

this Congress look for ways to increase the actual ownership share that employees have in their companies, as well as ways in which to encourage more companies to provide stock ownership for their employees. H.R. 3085 (as introduced) by Congressman Jenkins, as well as Senator Long's Expanded Ownership Act of 1981 (S. 1162), is a tremendous step forward in this regard. Those bills contain proposed amendments to the Internal Revenue Code which, if enacted, would create a strong incentive for companies to allow their employees to acquire all, or substantially all, of the stock in the company. Such an action would produce landmark results by removing obstacles which have prevented such employee purchases.

For example, one of the major problems which employees have had in trying to purchase a major ownership interest in their company has been the fact that ESOPs have been traditionally lumped together with other employee benefit plans under the Internal Revenue Code. To encourage companies to adopt and maintain plans to provide a retirement income for their employees, the Internal Revenue Code provides a tax deduction for an employer which funds such a plan. However, to assure that an employer will not use a tax incentive like this as a way of significantly reducing its Federal income taxes and simply providing a benefit for a limited number of high salaried people, the Code also imposes strict limitations on how much of a tax deduction can be available to an employer in any year for contributions to such plans and how much these contributions can benefit any individual employee. In the traditional pension plan, profit sharing plan or stock bonus plan, these limitations may have some justification. However, when employees are attempting to buy total ownership of their company through an ESOP, these limitations have a debilitating effect.

For example, the Code provides that an employer may not contribute on a tax deductible basis more than 25% of the total wages and salaries of all employees covered under all qualified employee plans maintained by that employer. At the same time, the Code provides that not more than 25% of an employee's compensation may be allocated to his accounts under all defined contribution plans maintained by the employer. However, when these limitations are applied to an ESOP through which the employees are trying to buy complete

ownership of the company, they can totally preclude such a transaction. This is because the amount of money which the employees can borrow through an ESOP is directly dependent upon the length of time over which a lender will make money available to the ESOP and the speed at which the money can be repaid. Since the value of many companies is in excess of the total wages and salaries paid to its employees, a provision which limits the employer's ability to contribute to the plan to 25% of the wages and salaries paid to its employees is clearly a severe limitation. When this is compounded by the fact that this 25% limit applies to the ESOP and any other plans maintained by the employer, it literally makes it impossible for the employees to buy the company. The same would be true with respect to the limitation on allocations to any employee's account under these plans. If it is ever to be possible for employees to purchase 100% of the stock in their company, some relief has to be created. The provisions in H.R. 3085 simply provide that, if an ESOP is being used to acquire all or substantially all of the company as part of the traditional leveraged ESOP, then the employer contributions which can be made on a tax deductible basis, and the amount allocated to each employee's account under the ESOP, can equal 25% of the total pay of all covered employees irrespective of whether or not the employer maintains any other qualified plans. S. 1162 also includes provisions which would modify and increase the present 25% limitations in the case of a leveraged ESOP.

Also, H.R. 3085 and S. 1162 would remove a requirement which has frustrated many companies which have adopted ESOPs for their employees. In the Internal Revenue Code, as a trade-off for the tax deduction which is provided for employer contributions to qualified plans and the tax-deferred treatment of employee benefits, there is a provision which imposes tax liability on these employees immediately upon receiving distribution of such benefits. This means that any employee who receives a distribution of stock from an ESOP, unless he is independently wealthy and able to pay the taxes due on the amount of his distribution, must sell the stock in order to pay his tax liability. In recognition of

this anomoly, in the Revenue Act of 1978, the Treasury Department agreed to permit ESOPs to distribute a participant's benefits to him in cash, provided that the distribution may, if the employee demands, be made in stock. While this concession was at least a partial solution to a continuing problem, it still does not totally alleviate it. For a company to issue a stock certificate, then issue a check to repurchase the stock certificate, and then cancel the stock certificate, can be an extremely costly expenditure. The reality is that almost every employee of a closely-held company will elect to receive cash rather than stock, and that those employees who elect to receive the stock almost immediately request that the stock be repurchased so that they will have sufficient cash to pay the taxes due on the distribution and have the money to spend. It is important to remember that we are now referring to stock which is clcsely held and that there is no other market for stock. It would be far better to provide, a provided in H.R. 3085 and S. 1162, that if the employees own all, or substantially all, of the stock of the company, the benefits of all participants from the ESOP will be distributable in cash.

An additional factor must be recognized. This would only apply in a case of a totally employee-owned company. If the employees are to own all the company, then the stock should continue to remain held for the benefit of current employees rather than being distributed out to former employees or their beneficiaries. In such a case, the distributees will have no continuing interest in the success of the company and will have no input on its future economic status. Also, new employees who join the company should have access to stock ownership, and this could be provided by the stock which was in the account of a terminated participant and which remained in the plan when his benefit was distributed to him in cash.

Finally, S. 1162 and H.R. 3085 propose that a continuing problem for companies which have TRASOPs be resolved. There are now approximately 1500 TRASOPs in the United States. Most of these have been adopted by the large, capital intensive corporations. These corporations have

numerous subsidiaries and divisions. In any economic climate, a constant series of acquisitions and divestitures of subsidiaries and divisions occurs. This has created a significant problem for companies which have adopted TRASOPs and which have extended the benefit of stock ownership to the employees of their subsidiaries and divisions.

When a subsidiary or division is sold, the employees are no longer the direct or indirect employees of the corporation which established the TRASOP and whose stock is used to fund the TRASOP. They became totally unrelated as a result of the sale. However, when Congress created the TRASOP in 1975, there was a recognized desire to encourage employees to remain shareholders. Accordingly, a rule was established which said that an employee's benefit may not be distributed to him from TRASOP until 84 months have passed from the date the stock was allocated to his account. Although certain exceptions were created to this rule (such as actual separation from service), the sale of a division or subsidiary was not one of them. We believe that the Administration will agree that such a situation was simply not considered at the time the 84-month rule was adopted. It would be far better to permit an employee's TRASOP benefit to be distributed to him, irrespective of this 84-month rule, if the division or subsidiary for which he works is sold by the parent corporation, even if he continues his employment. At that point, he would simply be a shareholder like any other shareholder and the stock should be his to do with what he pleases.

The ESOP Association believes very strongly that the other provisions in H.R. 3085 will have a major impact on the ability of employees to acquire an ownership interest in their companies. The TRASOP provision would clear up a technical problem which, if left unattended, will reduce the willingness of corporations to establish TRASOPs and permit employees of various divisions and subsidiaries to participate in them. None of these proposals is a "get-rich-quick" scheme. None of these proposals would work to the negative benefit of employees, since if they own all, or substantially of the stock of the company, they are the company. The possible conflict between the interest of the

shareholders and the interests of the employees will simply not exist, because the same people make up both groups. In each case, we are stimulating the ability of employees to become major beneficial shareholders of their employer. For these reasons, we strongly urge the Committee to give serious consideration to the provisions of H.R. 3085 and to include them in any tax legislation which is enacted this year.

In addition to the provisions of H.R. 3085, we also encourage the Committee to act favorably upon other ESOP provisions which have been included in S. 1162, as introduced by Senator Long and 30 other Senators. Some of these provisions are merely "technical" amendments to the Internal Revenue Code, intended to correct certain ESOP and TRASOP problems created under tax legislation over the past six years. Other provisions would provide additional tax incentives for companies to provide meaningful stock ownership benefits for their employees, while at the same time addressing the important issues of capital formation and employee productivity.

The "experiment" with TRASOPs since 1975 has proved to be most successful. The 1978 Revenue Act for the first time included the TRASOP as a permanent part of the Internal Revenue Code, but the additional investment tax credits available for TRASOP contributions are scheduled to expire at the end of 1983. We strongly recommend that Code Section 46(a)(2)(E) be amended to provided for permanence of the TRASOP credits.

At the same time, it is clear that the availability of TRASOPs is largely limited to larger, capital-intensive corporations. Millions of employees are being denied the opportunity of sharing in stock ownership benefits because their employers do not generate sufficient investment tax credits to make the TRASOP attractive. For this reason, we strongly recommend to the Committee that it take action to approve the concept of the "labor intensive" TRASOP which was first introduced in proposed legislation by Senator Long in 1978. Under this proposal, a tax credit equal to 1% of covered payroll would be available for TRASOP contributions as an alternative to the present additional 1% and 1/2% investment tax credits. This alternative TRASOP, if enacted, would certainly result in a significant increase in the number of TRASOPs and the number of employees benefiting from the TRASOP provisions. These provisions are included in S. 1162, the Expanded Ownership Act of 1981.

We also recommend one additional modification to the present TRASOP provisions, relating to the extra 1/2% credit available when employee matching contributions are made. the present Code provisions create excessive administrative burdens and costs to employers which collect the employees contributions. It is often difficult to "match up" the amount of employee contributions to the amount of the extra investment tax credit. We suggest that the Code be amended to permit the employer to make a tax deductible contribution to the TRASOP to match the additional 1/2% credit contributions, thereby eliminating the need for collecting employee contributions. We believe that many employers would take advantage of such an alternative in order to provide for more meaningful TRASOP participation by all employees.

With regard to ESOPs and leveraged ESOPs, there are a number of additional tax incentives which have been proposed as a means of further encouraging substantial "ownership sharing" for employees. We recommend that the Committee approve the proposal in S. 1162 to allow a corporate tax deduction for dividends paid on ESOP-held stock, so long as such dividends are "passed-through to participating employees. This would provide a tax incentive for giving employees the same right to share currently in dividend income as is provided to direct shareholders, thus making the ESOP more meaningful to employees. This provision should not appear to have a major impact on tax revenues, as the employees would be currently taxable on these amounts which are deductible by the employer.

We also encourage the Committee to act favorably upon the proposal in S. 1162 to allow a "charitable" deduction (for income, estate and gift tax purposes) for a donation of stock to an ESOP by a shareholder. S. 1162 also permits an ESOP to assume estate tax liability in the event employer stock is left to employees (through an ESOP) by an estate. These provisions would encourage wealthy individuals to provide additional stock to employees as an alternative to contributions to private foundations or other charitable institutions, thereby insuring that such assets will remain in private ownership, with the income thereon ultimately being subject to taxation.

The 1978 Revenue Act and the 1979 Technical Correction Act modified the definition of "employer securities" for purposes of leveraged ESOPs. Under the present Code provisions, nonvoting common stock of a closely-held corporation is generally prohibited in connection with an ESOP loan transaction. In a number of situations, the only stock available for purchase by an ESOP in nonvoting common stock held by a shareholder of the employer. It is unfortunate that present law would not now permit the ESOP to leverage the purchase of that stock, thereby denying ESOP participants the opportunity to share in the ownership and growth attributable to that stock. We recommend that Section 409(A)(1) of the Code be amended to permit an ESOP to acquire nonvoting stock through the use of an ESOP loan, as provided in S. 1162.

The 1978 Revenue Act included provisions which require the pass-through of voting rights to ESOP participants in certain situations. Although we believe that voting rights for employees may be desirable, this requirement under the law has had a "chilling effect" on the establishment of ESOPs. This Committee (in December, 1979 and May, 1980) reported out bills which included a deletion of Section 401(a)(22) from the Internal Revenue Code. We urge this Committee to take efforts to see that such a provision is enacted at the earliest possible date.

In connection with leveraged ESOPs, we recommend that the Committee consider amending the provisions of Code Sections 404(a) and 415(c) to modify the limitations on ESOP contributions which are applied to the payments on an ESOP loan. Specifically, we suggest that employer contributions which are used by the ESOP to repay interest on a loan be tax deductible in addition to the normal limitations on deductions, and that such contributions not be treated as "annual additions" for purposes of the individual allocation limits applicable to ESOPs. These amendments (included in S. 1162) would further encourage companies to utilize ESOP financing of capital growth, while providing stock ownership interest for employees.

We certainly recognize the outstanding efforts of Senator Long and the other members of the Committee in creating tax incentives to encourage employee ownership. We believe that the ESOP concept, as strengthened through legislation over the past seven years, has proved to be an important factor in the areas of employee benefits and corporate finance. It is now, however, to provide more meaningful incentives in order to further expand employee ownership of American business. We are convinced that the use of ESOPs will strengthen our economy, will aid in the creation of new capital and will enhance the productivity of corporations and their employees. Our Association strongly supports the proposals for new ESOP legislation which we have discussed and urges the Committee to include meaningful ESOP incentives in this year's tax cut legislation.

TESTIMONY

TO THE

UNITED STATES SENATE
COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

MONDAY NOV. 19, 1979

WASHINGTON, D.C.

By

ROBERT L. STRICKLAND
Chairman of the Board
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Summary of Principal Points

1. *Lowe's Companies, Inc. strongly endorses value of Employee Stock Ownership.*

2. *18 years of Lowe's Employee Stock Ownership proves that the concept motivates, creates incentive, creates productivity, and creates economic growth.*

3. *Lowe's growth from 6 stores to 205, from $18,000,000 in sales to $900,000,000 inseparable from substantial Employee Stock Ownership.*

4. *Success of Lowe's and its employees publicized by FORTUNE, NEWSWEEK, and others.*

5. *Value of Employee Stock Ownership concept attested to by former and present Lowe's employees.*

6. *Lowe's experience cited by Louis O. Kelso, Esquire, widely considered as "Father" of Employee Stock Ownership concept, as "successful yardstick for all U. S. corporations to try to match."*

7. *Survey of benefits of Employee Stock Ownership for Stockholders who are not employees is cited.*

8. *Increased national Employee Stock Ownership is a powerful tactic to promote improved national economic teamwork and productivity.*

9. *Productivity measurements of sales and earnings per employee show Lowe's outstrips competition.*

10. *Lowe's expresses appreciation to Senator Proxmire and the Senate Committee on Banking, Housing, and Urban Affairs for their consideration of expansion of the Employee Stock Ownership concept.*

84-226 O—81——48

Mr. Chairman and Members of the Senate Banking Committee -- good morning.

My name is Robert L. Strickland, Chairman of Lowe's Companies, Inc. I welcome this opportunity to vigorously endorse the unique intrinsic value of Employee Stock Ownership.

I am a businessman who believes deeply in motivation and productivity, and through 18 years with Lowe's, I have watched employee stock ownership work, and work well! From salesmen to truck drivers, from secretaries to store managers, the motivation, productivity, and achievements of Lowe's employees are a matter of historical fact and documented public record.

Lowe's is a group of retail stores, selling building materials to home builders and home owners in the Southeastern quadrant of our nation, from Indiana to Pennsylvania to Florida to Texas, and with one-fourth our stores in North Carolina.

In 1957, when Lowe's had six stores doing about $18,000,000, I went to visit the company for a job interview. Carl Buchan, the founder and owner, took me to meet the local store manager. We walked into the warehouse and over to the damaged merchandise area. He asked the manager, "What is that?" "Why, its our damaged merchandise, sir." "Look at it more closely and tell me what you see." "Well, that's a damaged water pump, and a dented refrigerator, and windows with broken glass." Buchan said, "That's not what I see when I look over there - what I see is money - my money - because I paid for it - and before the year is out, we're going to have a plan whereby part of that will belong to you and the other employees, and then when you look you'll see money too, and you'll

take better care of your money than you're doing now, and consequently, you'll take better care of my money!"

In July of 1957, Buchan did just that by establishing Lowe's Profit-Sharing Plan, with membership for every single Lowe's employee, and then subsequently he gave the Plan the option to buy his stock, periodically during his life, and the remainder upon his death.

He died in 1960, and in 1961, after financial settlement with his estate and a public stock offering, Lowe's employees, through the Profit-Sharing Plan, wound up with 48% ownership of the company's stock.

Lowe's employees have always been inspired by Buchan's vision, his desire for growth, and his pioneering commitment to employee stock ownership.

Today, those six stores have grown to 205 in 19 states. Our $18,000,000 annual sales volume has grown to $900,000,000. The stock, adjusted for splits and dividends, sold for $1.02 in 1961. It's trading now for about $18.00. Many of our employees became wealthy in the process, and the success of Lowe's employee stock ownership began making news.

FORTUNE magazine in 1972 quoted our former Chairman, "We are convinced that profit sharing (and its employee stock ownership) gives our employees a direct, personal self-interest in improving the company's earnings." FORTUNE went on to say "The bounty springs from the fund's portfolio, 90% of which is invested in Lowe's common stock." (Exhibit 1)

NEWSWEEK magazine in 1975 featured Charles Valentine, a $125 a week warehouseman, who retired after 17 years with $660,000 worth of Lowe's stock and cash. (Exhibit 2) NEWSWEEK said "90% of the money is invested in Lowe's stock - and that's the secret."

The CHARLOTTE OBSERVER headlined Ferrell Bryant, a truck driver who "Retired Rich." (Exhibit 3)

In Lowe's own report to employees, we featured Mrs. Mary Marsh, a secretary, (Exhibit 4) who stated, "because it is based on Lowe's stock, it's really an incentive to the employees to help make the company grow and prosper", and also our first six figure man, Mr. Spence Bumgarner (Exhibit 5) who worked for our lumber company subsidiary for 13 years. When he retired, his $150,000 fund balance was greater than the book value of the lumber company!

The Profit Sharing Research Council ran this Cover Story, "Why Lowe's Grows" and also featured a Store Manager, a Salesman, and a Warehouseman, all three of whom retired with balances ranging from $400,000 to $2,000,000. The store manager says "It wasn't until the Plan began buying Lowe's stock that we paid attention." (Exhibits 6, 7, 8, and 9) And we were delighted when in 1976 the Honorable Louis Kelso testified before the Senate Finance Committee and told the Lowe's story of employee stock ownership success. (Exhibit 10)

Mr. Kelso is the creator of the Employee Stock Ownership concept, and has said on many occasions that Lowe's Profit-Sharing Plan was in reality an Employee Stock Ownership Plan because 80 to 90% of the fund's assets were invested in company stock.

Mr. Chairman, these success stories were created by:

A. Employee Stock Ownership.

B. The motivation and productivity which was thereby created.

C. The growth in profitability which thereby ensued.

D. The increase in the price of Lowe's stock as Lowe's incentives and growth pattern were recognized by the stock market and financial community.

But what about those shareholders who are not employees? Do they benefit from employee stock ownership? The evidence is a convincing "yes". Mr. Bert Metzger is President of the Profit Sharing Research Foundation, and his comprehensive study "Does Profit Sharing Pay" authoritatively details how all shareholders are served by employee stock ownership. I quote, "What we need today are organizational incentives - programs which can motivate all factors contributing to corporate growth-stockholders, management, and employees. Employee profit sharing (and stock ownership) is multimotivational because it focuses attention on a common goal and rewards all factors." And this has been Lowe's experience.

The charts in Exhibit 11 to this paper show that employees of profit sharing companies produced more profit per employee, more profit on sales and a higher return on shareholder equity. This resulted in higher earnings, higher dividends and higher market value per share for all shareholders, including employees. And Mr. Metzger's letter of July 5 (Exhibit 12) confirms that the high performance companies were heavily invested in their own company's stock.

Mr. Chairman, the Washington Redskins are a team made up of three teams - offensive, defensive, and specialty. Those three teams have a shared goal - to win and be successful. When one considers three important forces in this country - employees, management, and government - it's getting to be a national tragedy that instead of cooperation and teamwork towards accomplishing shared goals, we have developed adversary relationships that are getting increasingly shrill and acrimonious and non-productive. Japan and OPEC are examples of how national and international teamwork can seize economic initiative and translate it into successful, competitive growth.

I believe, sir, that improved economic teamwork must be a priority national strategy, and that increased Employee Stock Ownership is a powerful tactic by which we can implement that strategy.

Well, how do I know it works? Ho do I know that Lowe's growth wasn't influenced more by geography, or the business we're in, or management skill, etc.

In the late '50's and early '60's, there were at least five companies like ours in the Sunbelt - one in Virginia, one in South Carolina, and one in Florida, and two in North Carolina. Same geography, same business, different management of course, but not bad management. Three of the companies didn't make it on their own and sold out. The fourth company is about one-fourth our size, and they have just adopted an Employee Stock Ownership Plan. Survival of the motivated, and the productive.

We use several productivity measurements, and in our Annual Reports, we compare ourselves to major retailers and competitors in Sales per Employee, and Net Profit per Employee.

When our employee plan acquired the stock in 1961, it had a dramatic effect on both sales and profits. For the four years prior to the stock acquisition, sales per employee per year averaged $81,000 and net profits after taxes averaged $1,891 per employee per year. For the four years after the acquisition, sales declined, to an average of $73,000, but net profit per employee per year increased 19% to $2,245.

The following table lists our progress in these important productivity measurements since then:

	Per Employee Per Year		
	Sales	Taxes Paid	Profits After Taxes
1966	$ 86,468	$2,801	$3,131
1971	$ 82,952	$3,128	$3,162
1976	$123,665	$4,555	$4,595

For 1978, although our Taxes and Profits figures are not directly comparable to our prior years, due to our change to LIFO accounting, they are comparable to, and were compared with, other major retailers in our Annual Report:

	Per Employee Per Year	
	Sales	Profits After Taxes
Sears	$ 40,000	$1,948
K-Mart	$ 48,900	$1,471
Penny	$ 48,500	$1,528
Wickes	$ 97,800	$1,973
Lowe's	$136,500	$4,084

(Sources of figures for other companies: Reprinted from the 1978 FORTUNE Directory by special permission. (c) 1978 TIME, INC.

To sum up the Revenue results of a small business that has grown fairly big, and plans to keep on growing, fueled by employee stock ownership; in 1960, we paid $641,000 in taxes - in 1979 we plan to pay $25,000,000 in taxes, and we look forward to remitting $50,000,000 in taxes, and our employees will own a larger percentage of the company than they do now.

Speaking for myself as an individual, I believe:

- The time for renewed national teamwork is now.
- The time for vastly increased employee stock ownership is now.
- The time for Senator Riegle's bill is now.

Mr. Chairman and Members of the Committee, Lowe's people believe in Employee Stock Ownership. We have seen it work to create incentive, productivity motivation, and wealth. We believe it is Creative Capitalism, and we are more firmly committed to the concept than ever before. We thank the Chairman and this Committee for your consideration to help make this great concept more important to this great country. Thank you, ladies and gentlemen.

Respectfully Submitted:
Robert L. Strickland

RLS/lb

Exhibit 1:
Source: December, 1972 *FORTUNE*

FORTUNE

Lowe's Companies

Profit sharing can be profitable indeed if you work for Lowe's Companies of North Wilkesboro, North Carolina, a chain of eighty-six building-supply outlets in the South. Two store managers retired recently with $3 million apiece—believed to have been record payouts for any profit-sharing trust. Thirteen store managers, salesmen, warehousemen, and office workers who retired last year collected a total of $17,500,000. Says Lowe's Chairman Edwin Duncan: "We are convinced that profit sharing gives our employees a direct, personal self-interest in improving the company's earnings."

The bounty springs from the fund's portfolio, 90 percent of which is invested in Lowe's common stock. The stock has zoomed to thirty-five times its initial value since the company went public in 1961 (recent price: $56 per share). Although Lowe's has paid only $8 million into the fund, the rise in the stock has pushed the net assets to more than $161 million. Whether profit sharing is the cause or the effect, the company has increased earnings 24 percent a year for ten years, to $9 million on sales of $234,600,000 for the fiscal year ended last July. As for Duncan, who at sixty-seven has no immediate plans to retire, he would collect a mere $900,000 if he quit tomorrow. But then, he has worked for Lowe's only eleven years.

Exhibit 2:

Newsweek

BUSINESS AND FINANCE — March 31, 1975

PROFIT SHARING:

Lowe's Largesse

Charles Valentine never made more than $125 a week in his seventeen years as a warehouse laborer—yet he retired with at least $660,000. Jack A. Allen, a store manager, is 33 and thinks he may stop working in four years—with $200,000 to enjoy. And personnel manager Cecil Murray, retired at 50, can afford to lavish money on his hilltop mansion or spread it around when he goes to the racetrack, since his retirement nest egg came to $3.5 million.

The three men did not save, win or inherit their retirement fortunes, but they did share one break. All three went to work for the Lowe's Companies, Inc., of North Wilkesboro, N.C., a building-supply chain that claims to have the richest profit-sharing fund in the U.S. on a per-capita basis. More than 50 Lowe's employees have retired with an equity in six figures. Says Murray, one of a score of millionaires the program has produced: "When you work all your life and all of a sudden you don't have to work, it's fantastic." Valentine, the son of a tenant farmer, now owns a dairy farm, two cattle

Charles Valentine on his farm: 'I never believed it would happen'

farms and two houses. "I never believed it would happen," he says.

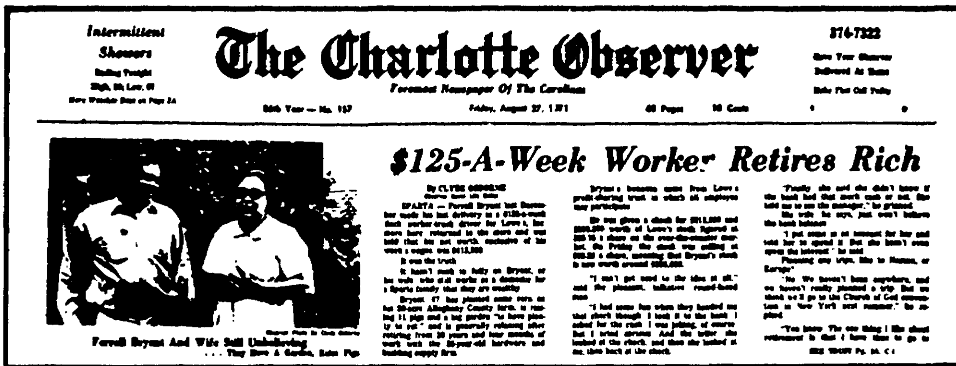
The sum that seems like a sudden windfall to Lowe's workers actually has accumulated over a period of fifteen years or more. The company, which runs 129 stores in sixteen Southern, mid-Atlantic and Midwest states, puts aside an amount equal to 15 per cent of an employee's salary each year on a store-by-store basis, if the store has met its profit goals; employees pay nothing into the fund. Ninety per cent of the money is invested in Lowe's stock—and that's the secret. The stock has performed spectacularly since it went public at $12.25 a share in 1961; allowing for splits the value of one share soared to about [illegible] in ten years. Even today, after the worst market shake-out in almost 40 years, the value of that initial share is still worth 25 times the offering price.

The profit-sharing fund is the biggest owner of Lowe's stock, and an employee may take his money and retire after fifteen years, regardless of age. The receipts are subject to regular and capital-gains taxes, which can be hefty, but there's still plenty left.

Stakes: The realization of what's at stake makes Lowe's 3,000 employees "profit-conscious and sales-conscious," according to Dwight E. Pardue, who administers the profit-sharing trust. "Quite frankly, we have the most dedicated employees in the world," he says, because "basically, they are working for themselves." Such incentive was the goal of H. Carl Buchan, Lowe's late co-founder, whose 889,180 shares of stock were sold to the fund at his death in 1960. Buchan had expanded Lowe's from a modest hardware business in North Wilkesboro into a modern, discount operation and figured the company would keep on growing if it were owned and controlled by those who built it. Buchan's faith has paid off. Lowe's sales have jumped from $119 million annually to $362 million over the past six years. Net earnings more than tripled during that time, from $4.6 million to $14.6 million. And Lowe's workers looked well-motivated indeed: profits per employee were two to three times better than those at a smoothly run pair of retailing giants, Sears and J.C. Penney.

—LYNN LANGWAY with JOSEPH B. CUMMING JR. in Atlanta

Exhibit 3:



Intermittent Showers

The Charlotte Observer

Foremost Newspaper Of The Carolinas

$125-A-Week Worker Retires Rich

Lowe's Profit Sharing made headlines in the Charlotte Observer.

Exhibit 4:
Source: Lowe's 1972 Profit-Sharing Annual Report

Mary Marsh... Profit Sharing the second time aound.

"You don't pay in any money. Then when you have to leave and you receive your profit sharing, you wonder, 'Do I deserve this?'" This is how Mary Marsh felt when, after 6½ years with Lowe's as a sales secretary, she left the company when she and her husband moved to Florida. Of course, she did deserve her profit sharing money, because, just like every Plan member, her efforts had helped make that profit possible. Lowe's management feels that it is in the true American entrepreneurial spirit that those who create profits should share in them. And that's why we have the profit sharing plan.

The Profit Sharing Plan was a big incentive for Mary to return to Lowe's when she moved back into the North Wilkesboro area from Florida. Now Mary is back at work as an executive secretary and is again participating in Lowe's Profit Sharing Plan.

Mary feels that the Profit Sharing Plan is really good because participation in the Plan does not cost the members anything. "And," "she continues, "because it is based on Lowe's stock, it helps keep you interested in the company. It's really an incentive to the employees to help make the company grow and prosper."

Exhibit 5:
Source: Lowe's 1972 Profit-Sharing Annual Report

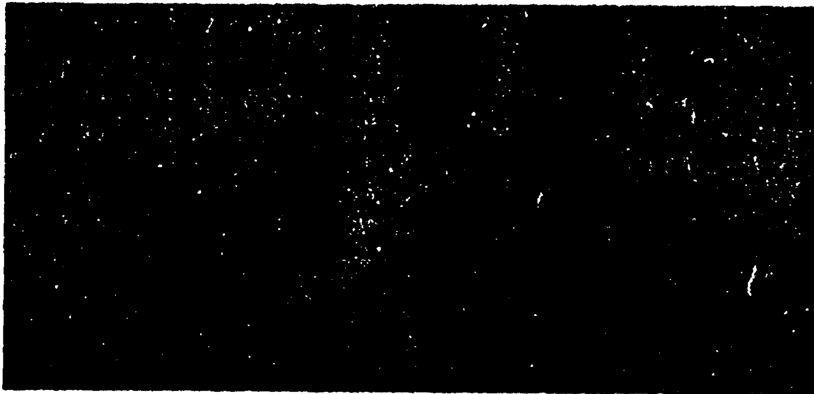
Lowe's first six-figure man, Spence Bumgarner

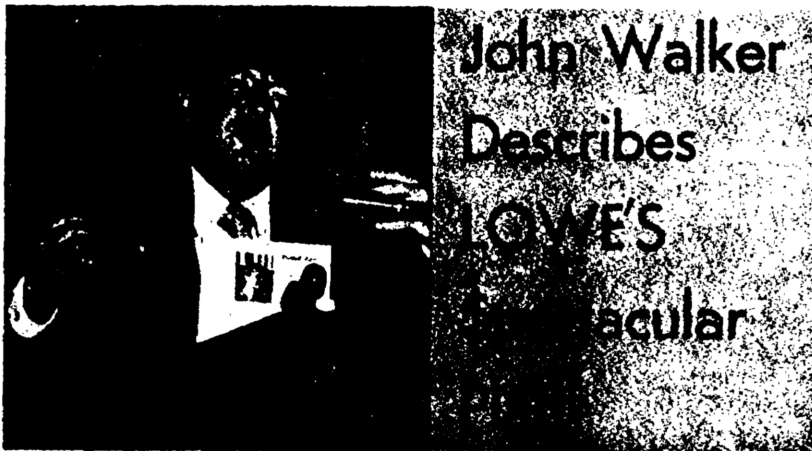
"They worked up this thing several years ago — kept telling us what a good deal it was — but like a doubting Thomas, I didn't think it'd amount to anything. But it sure did!" Indeed it did! J. S. "Spence" Bumgarner worked at Buchan Lumber Company as a lumber grader for 13 years; when he retired his Profit Sharing amounted to $150,000 — more than the net worth of Buchan Lumber at that time! "I was surprised to death. I wasn't figuring on getting but 50%." Because Spence was 65 when he retired, he vested 100% (forfeited none) of his profit sharing. "I'd always heard it was better to be born lucky than rich, and that was one time I believed it!" Spence had also worked for the old Oak Furniture Company for 29 years as a lumber grader.

What's Spence doing with his money? Helping his children and fixing up his home. "He let it run down for 40 years," his wife said. "Now it's going to take some time building it back up." "Yes," added Spence, "and Lowe's and Buchan Lumber are getting a lot of that profit sharing money back."

Spence's plans for the future are variable; he gardens, keeps milk cows, and works around his place. "I may work me up a hobby. I've got some wood-working tools my family gave me." Whatever, we wish Spence and his wife many years of healthy, happy retirement. Spence expressed his gratitude to Lowe's emphatically, "Tell all of them I think Lowe's is the greatest!"

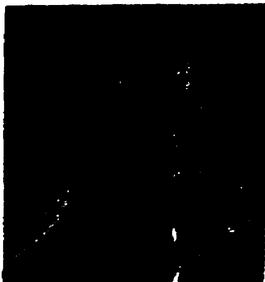
Exhibit 6:
Source: Profit-Sharing Council of America Monthly Bulletin





(Reprinted by special permission of the Profit Sharing Council of America)

Exhibit 7:
Source: Profit-Sharing Council of America Monthly Bulletin



The Executive

James Fred Walters Jr., who retired from Lowe's in 1972 after managing several of their stores, joined them in 1953 straight out of the Army when they had only three stores.

"I was just out of service and looking for work and jobs were scarce. So, when I heard they were hiring — the store was just six months old then — I went down and applied."

He adds, not without some pride, "Within six months I was their leading salesman."

And, when he retired, he was the third oldest employee in point of time. His Profit Sharing fund was worth more than $2,000,000.

"When they first created the plan in 1957, many of us didn't realize what it was or what it would become. It had no significance. It wasn't until the plan began buying Lowe's stock and we saw its value multiply — almost seven times over — that we paid attention."

Walters has a clear-eyed view of what makes the plan so successful. "It's the people. It attracts good people and it keeps good people and it gives them the incentive to make good money and to make their own contribution. There's no finer place to work — even now."

Walters' windfall hasn't changed his life much. He moved back to his hometown of Asheville, North Carolina, where he first started with Lowe's, bought a new home, and it occupies most of his time now.

He also contacted a local bank and engaged a lawyer to help him manage his funds. But he'll probably go back into business on his own some day.

"I'm only 44. I've got some good years left."

Exhibit 8:
Source: Profit Sharing Council of America Monthly Bulletin

The White Collar Worker

Archie Hayes, like Walters, came straight out of service and into Lowe's. Unlike Walters, he stayed at the same store in his home town of Sparta, North Carolina, throughout his career with the giant merchandiser.

He began in 1956 as a salesman, and retired 15 years later as a millionaire. His fully vested account was worth that much in 1971.

Hayes is just 42 years old.

He was qualified for his salesman's job. In the Air Force he had been assigned to supplies and tech-order distribution, so he was familiar with merchandise. As a salesman, he handled Lowe's complete line of goods and services.

The huge payoff hasn't changed Hayes' lifestyle too much.

"We still live in the same house, and have no plans to move. I just consider it all financial security for my family."

Hayes has a daughter, 19, in college, and a son, 10, in grammar school.

He took his account partly in cash and partly in Lowe's stock, and, with it, has been investing in real estate and some stock speculation. And he's doing it without any outside advisors.

His wife's reaction to the whole thing? "She thinks it's unbelievable."

So do a few others.

Exhibit 9:
Source: Profit-Sharing Council of America Monthly Bulletin

The Blue Collar Worker

Ferrell Bryan is one of Lowe's earliest employees. He began with the firm in 1950 as a warehouse boy, and, when he retired 21 years later, the last 14 as a truck driver, he was almost half-a-millionaire.

His Profit Sharing account was worth $426,000. His top salary at Lowe's at retirement was $125 a week. He was then 47.

Bryan took his fund half in cash and half in Lowe's stock. The cash he invested in a small farm near Sparta, North Carolina, and in savings accounts, and the stock he kept is now worth considerably more. Just like Lowe's, it keeps growing.

Bryan's lifestyle made a definite change, from truck driver, at which he had a near-perfect record, to farmer. He keeps some cattle, and enough crops to feed the cattle and put food on the table.

He calls the Profit Sharing plan the "best thing that ever happened in my life." Even toward the end, he couldn't believe it.

"It wasn't until some of the other old timers started to leave, and collect their accounts, that I knew it was true."

His wife had trouble believing it, too. She refused to quit her job until he had collected his account and the money was in the bank.

Bryan is still one of Lowe's best customers. "Anything I need for the farm or the home I go into the store in town. I know I'm going to get my money's worth. They've got the best goods and services around."

He ought to know. He handled a lot of it

Exhibit 10:
Source: Louis O. Kelso, Esquire

PRESS RELEASE

Washington, D.C.--Hold For Release Until Noon, Wednesday, March 31, 1976

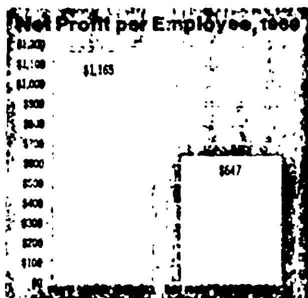
KELSO URGES SENATE TAX COMMITTEE TO MAKE AMERICAN WORKERS INTO MINI-CAPITALISTS

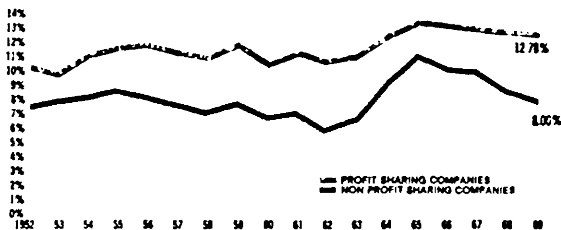
Louis O. Kelso testified before the Senate Finance Committee today on his proposals for restructuring the nation's tax laws to unharness America's underutilized manpower and technological potential, and to remove present tax barriers to new capital formation by making the ownership of new capital more accessible to American workers. To provide new incentives for saving capitalism and making it more relevant to our democratic ideals, Mr. Kelso called for Congress to establish as a national target for the remainder of the twentieth century the creation of opportunities for every worker, and eventually every consumer, to accumulate a tax-free capital estate of up to $500,000 over his working lifetime.

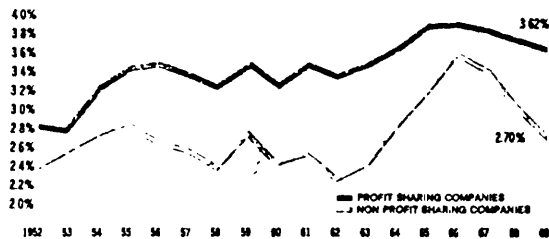
"What we are proposing is no less than the industrial counterpart to the Homestead Act", Kelso said. "Land is finite, but the potential for capital development is unlimited. Just as in 1862, when those Americans with limited means were given the chance to own and develop up to 160 acres of productive land, Americans should now be afforded the opportunity to become owners of significant holdings in our growing frontier of productive capital. By amending the nation's tax laws, we can begin to extend to every American a meaningful opportunity to carve out a personal stake in the multi-trillion dollar frontier of future capital formation."

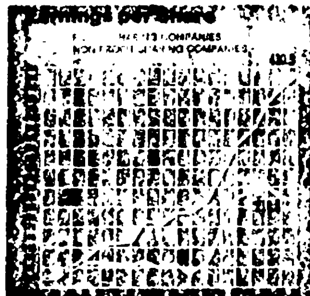
As an example of what he hopes would be accomplished on a national scale, Kelso related the story of Lowe's Companies, Inc., a North Wilkesboro, North Carolina-based building-supply chain, where a warehouse laborer who never made more than $125 a week in the 17 years he worked for the company, retired with over $660,000 in Lowe's stock without having contributed a cent. Kelso acknowledged this as the most successful example of what employee ownership might achieve, but suggested it as a yardstick for all U.S. corporations to try to match.

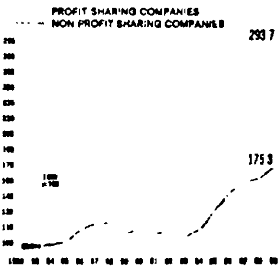
Exhibit 11:
Source Lowe's 1971 Annual Report











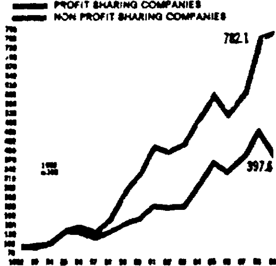


Exhibit 12:
Source: Bert L. Metzger, President Profit Sharing Research Foundation

PROFIT SHARING RESEARCH FOUNDATION

PSRF
1718 Sherman Avenue ■ Evanston, Illinois 60201 ■ (312) 869-8787
BERT L. METZGER, President

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JOHN W. LESLIE
Signode Corp.

July 5, 1978

Mr. Henry Church
Lowe's Companies, Inc.
Box 1111
North Wilkesboro, N.C. 28656

Dear Henry:

As a follow up to your phone call the other day I am pleased to send you and Bob some information which may be helpful in preparing appropriate testimony on the value of profit sharing and employee stock ownership.

The following items warrant your attention:

1) Our 1971 study entitled Does Profit Sharing Pay? in which the 5 companies with broad coverage profit sharing programs outperformed by substantial and widening margins the companies without profit sharing. Not so incidentally, the 5 broad coverage programs were all heavily invested in own company stock.

2) "Performance" data on 38 large profit sharing companies is compared to Fortune medians reflecting return on sales and equity. This information appears under the heading "Evidence of Superior Performance" in Vol. II of Profit Sharing in 38 Large Companies for the years 1973--1976 inclusive.

3) The prevalence and growth of profit sharing and ESOP plans--ie., current trends toward defined contribution plans, profit sharing programs and ESOPs.

4) Prevalence and extent of own company stock holdings among the 38 large profit sharing trusts. Thirty-six out of 38 invested their profit sharing funds to some extent in own company stock; 17 of 38 had from 60--100% of their portfolios in own company stock. Altogether $5.9 billion out of $9.9 billion (60%) was invested in own company stock by these 38 trusts at the end of 1976.

5) Over one million employees have a "piece of the action" through these 38 profit sharing programs.

6) The financial benefits for long-term participants under these profit sharing/share ownership programs exceeded typical pension benefits by modest-to-substantial margins in almost all cases. Twenty-seven out of the 33 companies who provided such data (82%) generated benefits under their profit sharing programs which ranged from 112% to 1011% of

the "pension standard."

You might also want to check the recent survey of ESOPs undertaken by five graduate U.C.L.A. students under the auspices of the ESOP Council of America.

I do hope that Bob will not focus in too narrowly on ESOPs as the only road to broad employee stock ownership.

Most ESOPs are funded by company contributions geared to corporate performance and, therefore, are "profit sharing" ESOPs. In addition, there is only a very thin line between an ESOP and an EPSOP. The latter is an Employee Profit Sharing and Ownership Plan. I would consider Lowe's former profit sharing program and Hallmark Cards current profit sharing program to be EPSOPs. Most of the programs in Does Profit Sharing Pay? and Profit Sharing in 38 Large Companies could also be described as EPSOPs. If a profit sharing program specifically designates that up to a certain percentage of the portfolio (eg. 25%, 50% or 100%) can be invested in own company stock, we have an EPSOP. Own company stock is consonant with the nature of such a trust and Congress, it seems, should bestow like tax incentives on EPSOPs as on ESOPs.

Bob Midkiff covers this point nicely in his article on "Helping Workers to Become Owners" in our PSRF booklet, New Horizons for Capitalism.

We hope this letter and enclosures prove useful. If we can help further or answer any questions, please don't hestitate to call on us.

Best regards,

President

BLM:mm
cc: Robert Strickland

[Hearing adjourned at 6:32 p.m.]

TAX REDUCTION PROPOSALS

WEDNESDAY, MAY 20, 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, Hon. Robert J. Dole (chairman) presiding.

Present: Senators Dole, Packwood, Chafee, Durenberger, Armstrong, Symms, Grassley, Long, Bradley, and Mitchell.

The CHAIRMAN. We will now start another day of hearings on the tax reduction proposals. Last night we were able to wind up by 7 p.m. We are hopeful today may be even better.

Before hearing our first illustrious witness, Senator Packwood would like to make a brief statement.

Senator Packwood.

Senator PACKWOOD. Several members asked yesterday where I was heading with the questions that I have been putting out. We will have a witness, today, from the Library of Congress who has prepared the basic research that has provided the questions I have been asking.

I am pretty much now done with the information. I gathered most of the conclusions and I should have a rundown on the financial figures from the Joint Committee on Taxation today.

It is my intention to try to put together a tax package that tilts very heavily toward productivity increases, capital formation.

It would not be 10-10-10. It will be a substantial variation from it. I would hope it will be a program that a fair number of the members of this committee could unite around. It will be less expensive than the President's program, but I think tilts sufficiently toward expanding savings, and capital formation for plants, factories, and creating jobs.

The CHAIRMAN. Senator Long, do you have any questions?

Senator LONG. No questions.

The CHAIRMAN. The first witness is our colleague from the great State of Connecticut, Senator Lowell Weicker. I understand Senator Sam Nunn will be joining you in a few moments.

We have a prepared statement from Senator Gary Hart which we will insert in the record.

PREPARED STATEMENT OF SENATOR GARY HART, SENATE FINANCE COMMITTEE

Thank you for the opportunity to testify before this committee. I would like to address myself to two issues today: First, the tax bill which the Senate will adopt this year; second, the need for long-term reform of the tax system as a whole. In

particular, I am proposing we create a National Commission on Taxation to propose major, needed changes.

There is little disagreement as to the two objectives we should set in formulating a tax bill this year.

First, we must relieve the increasing personal income tax burden caused by the rise in inflation. We all agree taxes should not rise simply because individual wages rise to keep up with inflation. For this reason, some form of personal tax cut to offset "bracket creep" must be adopted this year.

Second, we must take steps to ensure the tax code encourages investment and savings as much as possible.

And, of course, both objectives must be achieved in ways that retain the progressivity and fairness that are critical to a viable tax code, and indeed to government itself.

KEMP-ROTH: THE WRONG SOLUTION

The Administration has proposed to achieve both these goals in a single stroke—the Kemp-Roth tax cut. This would be a tragic mistake. Not only would Kemp-Roth fail to remedy our economic ills—it would make them worse.

Administration officials admit Kemp-Roth is not traditional economic medicine, but they urge us to try it anyway. They offer the remote hope that, if we do, inflation will miraculously abate, productivity will increase and the economy will rebound. Most economists agree this is not a standard prescription. Professor Tobin of Yale has described it as "economic laetrile."

There are several problems with Kemp-Roth. First, it would be seriously inflationary. It would spur consumption—not saving—in an economy that has no need for billions in excess demand. The Administration claims each taxpayer will save his "Kemp-Roth" cut so Kemp-Roth's billions will be invested in our nation's capital base. But this is unlikely to happen: the average American typically saves less than one-tenth of the money returned in a tax cut. Instead, Kemp-Roth will be a gigantic stimulus for consumption, which will heat up the economy and increase inflation.

At a time when our Nation plans and needs substantial increases in defense, it would be a grave mistake to stimulate private consumption as well. We made that mistake in the 1960's, and most economists agree that the result was to begin the inflationary disease that we're racked with today.

Second, Kemp-Roth would continue high government deficits and government borrowing. Unless equally massive spending cuts can be found and enacted to offset the $150 billion or more in lost revenues, adoption of the Kemp-Roth program would, over three years, guarantee deficits billions of dollars larger than any we've seen. One economic simulation performed for the Joint Economic Committee estimated a fiscal year 1984 deficit of almost $110 billion. Others are more moderate but still disturbing: The Congressional Budget Office estimated a deficit of $77.9 billion based upon the spending cuts identified thus far.

Whether one chooses estimates that are optimistic or pessimistic, it is obvious that Kemp-Roth would leave the Administration only one option for fighting inflation: tight money and high interest rates. This concern about the effect of Kemp-Roth is shared by respected leaders of the financial community, such as investment banker Henry Kaufman, who called Kemp-Roth "exceedingly expansionary." His words are echoed every day in the nation's bond markets, which grow weaker at even the prospect of Kemp-Roth.

Nor is Kemp-Roth just a one-time problem; it is a three-year guarantee of deficit spending. It would lock the nation into a series of regressive, consumption-oriented and inflationary tax reductions at a time when we all agree our primary task must be to maintain fiscal discipline and encourage investment.

Perhaps most disturbing, Kemp-Roth is a tax cut predominantly for the wealthy. Fully one-third of its benefits would go to taxpayers earning more than $50,000 per year. By contrast, this committee proposed last year a much more evenly distributed tax bill, for which the comparable percentage of the benefits going to the very wealthy was 18 percent.

Since you have had, and will have, before you a large number of witnesses testifying on the inadequacy of the Administration's business depreciation proposal, I will not take your time to do so myself. I would only note that last year the members of this committee—both majority and minority—developed a proposal you believed was an improvement over "10-5-3." You persuaded me then. And nothing that's happened since has changed my mind.

THE HART TAX PACKAGE FOR FISCAL YEAR 1982

I think we can do better than Kemp-Roth and "10-5-3." In the Senate Budget Committee this year, I proposed a one-year tax package that would: (1) increase investment; (2) reduce individual tax burdens; (3) maintain a sense of fairness; and, (4) preserve our chances for a balanced budget.

It would redress the burdens of inflation by widening brackets to offset it. It would increase productivity by reducing the marriage penalty that discourages women from entering the workforce. And it would encourage saving by expanding the availability of Individual Retirement Accounts. Overall it would provide about $23 billion in personal income tax cuts in fiscal year 1982.

This proposal also would increase investment by providing even more substantial cuts in business taxes—about $26 billion in fiscal 1982. It includes this committee's 1980 proposal for accelerated depreciation, a tax credit for research and development, and a reduction in the corporate tax rate in 1983. Furthermore, it would reduce inflation directly by providing a credit to employers to offset this year's increase in Social Security payroll tax.

Many of these proposals were adopted by this committee last year. They still make a great deal of sense for this year. I have attached a copy of my proposals and I hope you will consider them.

But the basic principles are more important than the individual provisions. I urge you to develop a one-year bill that offsets the effects of inflation on individuals but reserves the bulk of its revenues for investment.

MORE BASIC CHANGES ARE NEEDED

What we really need in the future, however, is more than tinkering with the system. And my main purpose in coming before you this morning is to urge the committee to begin thinking about a complete overhaul of our tax system in addition to this year's tax bill.

Our economic problems demand real tax reform. The tax laws are arcane. They are incomprehensible to the average citizen You know and I know our tax code can never be easy bedtime reading. But what American taxpayers want and have a right to expect is a system that is effective and fair. And right now, it is neither.

It is time for us to consider fundamental issues and basic changes. Does the tax code actually penalize business investment? Would individuals save more if savings were taxed less? Should we drastically revise business taxation, as economist Lester Thurow of MIT and others have suggested? Which of the numerous savings incentives—if any—is justified? Which is best?

These are questions that we simply cannot answer quickly. And we should not try to. But I am concerned that, as we rush forward with a tax bill this year, we will lose the incentive to reflect more broadly and to consider real reforms.

A NATIONAL COMMISSION ON TAXATION

For this reason, I propose we undertake a special effort and create a National Commission on Taxation.

An independent commission is entirely justified. Resolving these difficult questions will require careful study and analysis, extensive public hearings and long discussion. It is not the sort of task that we can complete during an already overcrowded legislative session.

Three years ago, the Congress recognized the need for assistance in resolving the complicated issues that we face in reauthorizing the Clean Air Act. In the 1977 Admendments, we chartered the National Commission on Air Quality to review the effectiveness of the law and to recommend possible changes in preparation for this year's revision. The Commission recently proposed over 100 changes in the law to the Congress—ranging from the technical to the conceptual. As Chairman of the Commission, I can tell you its work was enormously useful and will help the Environment and Public Works Committee write a new bill this year..

The same approach would work here as well. A National Commission on Taxation would be responsible over the next two years for reviewing and analyzing the issues we're discussing here. The Commission could help resolve some of these questions and recommend a policy or set of policies to the Congress.

There are a number of issues that a Commission could help this committee and the Congress decide:

First, to what extent are major revisions justified to increase the level of savings and investment? There is, as you well know, some disagreement as to how much personal saving will increase if more favorable tax treatment is provided. Some, such as Professor Michael Boskin of Stanford, think the response would be substantial; other researches disagree.

Second, if we believe we can increase saving patterns substantially, what changes would be most effective? Congress has before it a half dozen so-called "savings incentives." We need a thorough analysis of these, but we should consider others as well.

For example, many savings proposals would eliminate the interest or dividends earned on particular kinds of investments, such as stock or savings accounts, but would still require full taxation of the income that is being invested. A fairer and more effective approach might be to defer taxing income that is invested or saved until the money is withdrawn and spent. This approach would encourage investment, but it would still ensure that all income is taxed eventually.

We could consider establishing a new form of tax-deferred savings account, similar to the Individual Retirement Account (IRA). The chief difference would be to allow this special account to be used for any purpose, such as education or housing, and not simply retirement. Furthermore, no restriction would be imposed on where or how an individual should invest—the free market could decide that. We should also set higher limits on the amount of income that could be invested in such a tax deferred account than IRA accounts allow—perhaps $3,000 a year.

A more basic change would be to shift from our current system of taxing income to one which taxes spending instead. Some economists believe that by taxing only income that is spent and eliminating taxes on income that is saved and invested, we could spur major changes in saving habits. Of course, so basic a change in our tax code poses a multitude of difficulties. It would involve changes in accounting, in the treatment of estates and inheritances and in the taxation of personal wealth and income earned overseas. It is precisely because the issues are so complex that they should be charged to a separate commission that can pay full attention to the task.

Third, what is the most appropriate way to tax capital gains and business income? The commission could provide independent information and judgment on the role of taxes in the investment decisions companies make.

Fourth, what tax policies might be effective in helping U.S. companies compete abroad, and what role should the tax system play in meeting those goals?

Of course, the ultimate job of refining and improving the nation's tax code is ours. But a National Commission on Taxation could be a useful tool in this difficult and important job. I urge the committee to consider creating such a body in any tax bill passed this year.

For the nation needs and wants change. As President Reagan concluded when he spoke before Congress in February: "The people are watching and waiting. They don't demand miracles. They do expect us to act."

Fact Sheet on the Hart Tax Proposal

PERSONAL INCOME TAX CUTS: MINUS $22.8 BILLION

One year indexing—-$18.1 billion: Widen tax brackets; increase the standard deduction; increase the zero bracket amount; increase the earned income tax credit; and future cuts depend on cutting spending.

Marriage penalty offset—-$3.8 billion: partially offset the marriage penalty by allowing a deduction of part of the earnings of the second member of a two wage-earner family.

Savings incentive—the Dole IRA proposal—-$.9 billion: Expand the eligibility for IRA pension accounts so those with inadequate pension funds could open IRA savings accounts.

BUSINESS TAX CUTS: MINUS $25.7 BILLION: ACCELERATED DEPRECIATION—-$17.1 BILLION: THE "2-4-7-10" PROPOSAL DEVELOPED BY THE SENATE FINANCE COMMITTEE.

R&D tax credit—-$.6 billion: A tax credit for incremental research and development.

Social Security tax increase offset—-a$8 billion: A deduction against corporate income taxes for the amount of the employer's portion of the 1981 social security tax increase.

1983 Corporate tax rate cut—-$0: Reduce corporate tax rate from 48 to 40 percent, effective in 1983 (Hollings proposal).

OTHER TAX POLICY CHANGES: PLUS $9.9 BILLION

Oil import fee, to finance the SPRO—+$3 billion: A fee on oil imports, to be earmarked for financing the Strategic Petroleum reserve.

Reductions in tax benefit programs—+$5 billion: Require sharing of effect of cuts by elimination of outdated, unproductive tax expenditures (leave specific decision to Finance Committee).

More effective IRS collection and enforcement—+$1.9 billion (CBO estimate).

Hart tax proposal—April 8, 1981

[In billions of dollars]

	Revenue change fiscal year 1982
Personal tax cuts:	
1 year indexing[1]	−18.1
Marriage penalty offset	−3.8
Savings incentive (Dole IRA proposal)	−.9
Total	(−22.8)
Business tax cuts	
Accelerated depreciation (2-4-7-10)	−17.1
R. & D. tax credit	−.6
Social security tax increase offset (business only)	−8.0
Corporate rate cut in 1983 to 40 percent	
Total	(−25.7)
Other Tax Policy Changes:	
Oil import fee for SPR	+3.0
Reductions in tax benefit programs	+5.0
More effective IRS and agency collection and enforcement (CBO estimate)	+1.9
Total	(+9.9)
Total reductions proposed by:	
Administration	−51.3
1980 Finance Committee	−51.1
Hollings	−25.5
Hart	−38.6

[1] Size of futuer year personal cuts to offset inflation to be determined in future sessions of Congress based on spending cuts.

	Fiscal year—			
	1981	1982	1983	1984
Net revenue reduction	−8.4	−38.6	[1] −55.0	[1] −68.4
Hart revenue mark	600.1	663.0	751.0	846.8

[1] Size of future year personal cuts to offset inflation to be determined in future sessions of Congress based on spending cuts.

The CHAIRMAN. Senator Weicker, you may proceed any way you wish.

STATEMENT OF HON. LOWELL WEICKER, JR., U.S. SENATOR, CHAIRMAN, U.S. SENATE COMMITTEE ON SMALL BUSINESS

Senator WEICKER. Thank you very much, Mr. Chairman, Senator Packwood, and Senator Long.

I am going to read my statement. I think this is probably the only chance I will have to express myself on the matter of taxation before the committee that can do something about it.

As you know, I have, along with 25 of my colleagues, have put together a rather comprehensive small business tax bill. There is nothing my Small Business Committee can do about that. The matter lies in your hands, so this being the only shot that I am going to have, I am going to make the most of it and hopefully have my thoughts in some measure enacted into law.

Senator Nunn will be with me shortly and will also present testimony on the importance of including capital investment incentives for small business in the tax bill to be considered by this committee and the Congress this year.

Senator Nunn and I, along with Senator Durenberger, Senator Packwood, and Senator Baucus of this committee are coauthors of Senate bill 360, the Omnibus Small Business Capital Formation Act of 1981 which now has 25 cosponsors, on both sides of the aisle of every region of our country.

I also know that Senator Bentsen, along with Senators Danforth, Baucus, Mitchell, and Chafee, recently introduced Senate bill 1140 which includes some of the provisions of S. 360.

This committee will have major responsibility for the development of tax law and policy appropriate to our country's needs in this decade, specifically to stimulate now-stagnant U.S. productivity, promote capital investment for the modernization of U.S. industry, and encourage greater personal savings and investment and generally to spur economic growth on the supply side, decelerate rather than accelerate inflation.

I am convinced that the President is right when he says we are in the worst economic mess since the Great Depression, but I am deeply concerned that things could get much worse before they get better.

I believe that the high inflation, high interest occurring now precipitate a severe recession lasting into 1982. This is why I believe there is such a grave responsibility on the members of this committee to write a tax bill that is properly tailored to fit the problems and potentials of our economy.

There is a rare chance to correct the high spending, low investment imbalances that have plagued the economy for a decade or more.

The risk of fanning the flames of inflation is enormous. The economy is very brittle right now and a grievous error in policy in 1981 could flaw the system for the rest of decade. Like the Vietnam buildup period of 1965, 1981 could be the watershed year for the U.S. economy for 15 to 20 years.

For these reasons, Mr. Chairman, I have consistently expressed my opposition to enactment of the huge 30 percent across-the-board personal income tax rate cut. In my judgment this is not the time for such economic experimentation.

Where there is risk, there is also opportunity. Our generation, in this Congress, can charter a new and vigorous course for the country and we can begin to reverse an era of stagnation of inflation, if only we will have wisdom, discernment, and resolve. In the area of tax policy, perhaps more so than in any other, we are going to need these qualities.

The tax bill reported by this committee must be right. It must be based not on good intentions, but on a clear sense of where we are and have been and where we must go and how in this decade. Tax reduction should be linked to achieved Federal spending reductions. Within this limited framework, about $40 billion should be targeted to capital investment, savings, and job creation.

In this connection, Mr. Chairman, I am here today to seek consideration of our recommendations for investment incentives for small business. The priorities I am about to lay before the committee meet the fundamental tests I believe all tax proposals must meet for this bill.

There are supply side tax incentives for capital investment and productivity. Approval of these priority measures by the Finance Committee enable one of the most productive sectors of the American economy to participate fully in our Nation's economic recovery program.

The record is clear that small business is really the essence of supply side economics. Small business accounts for 90 percent of the new private sectors jobs. Small business is responsible for 43 percent of the gross national product.

Small businesses, according to the National Science Foundation, produce four times more innovations than medium-sized companies and twenty-four times more innovations than large companies for every research and development dollar.

Now, Mr. Chairman, let me also say this. I would hope that consideration for these recommendations that I am about ready to make will be given in this bill.

I am enough of a realist to know, regardless of the rhetoric that issues forth from the White House to put off those making different requests, there is not going to be any second bill. This is it. This is the bill.

I would also hope that this committee—I think that this Committee has some of the finest minds in the U.S. Senate and believe me I have far more faith in what can issue forth from these minds, a combination of these minds, than just the game plan as set forth by one or two persons in the administration and I hope that you will do your own thinking here and create your own bill.

The White House Conference on Small Business held in 1980 estimated that at projected labor force growth rates, the United States will need 11.8 million new jobs in the 1980's to accommodate net increases in the work force.

If the hiring contributions of Government and large companies continue at present levels, which is unlikely, about 9 million new jobs will have to come from small business, an average of almost 1 million a year.

To accomplish this hiring requirement, the White House conference concluded that small business would need three things.

One, more external capital; two, greater retained earnings; and three, better management.

I am here, today, to suggest a number of ways that tax incentives can answer these needs and unlease a tremendous productivity of small business.

As the administration bill now stands, small business would not be afforded sufficient opportunity incentive to contribute fully in the planned U.S. economic revival.

The 10-5-3 proposal is good as far as it goes, but it is aimed primarily at the larger capital-intensive firms which invest in longer lived assets and thus, does not really hit the small business sector which tends to be somewhat more labor-intensive in corporate tax brackets where the benefit of depreciation deductions is relatively small.

I am now saying reject 10-5-3, indeed, the 5-3 portion of 10-5-3 was a big part of S. 360. I am still a strong supporter of simplified and accelerated depreciation as a priority item for small business. But, I am saying supplement 10-5-3 or whatever depreciation

regime you adopt with specific small-business-oriented tax incentives.

On the basis of hearings held by the Small Business Committee on this subject on March 9, 1981, and the prodigious amount of committee work in considering the various proposals included in S. 360, I am prepared to recommend the following priorities for capital investment and productivity boosting tax incentives for small business.

You will note that I list these priorities generically because I understand the committee will need to fill in the details based on revenue and other considerations.

One, further graduation in reduction of corporate income tax rates and an increase in the surtax exemption. This has been a principal element of every major small business association.

Two, the capital gains rollover permitting an individual to sell an interest in small business and defer any tax consequences so long as the proceeds are reinvested in another small business within a certain period of time.

Three, estate and gift tax reforms. Certain changes are necessary to relieve the heavy burden of estate taxes upon the continuity of small business, especially the estate tax exemption presently at $150,000 and the marital deduction.

Four, the small business participating debenture, a new financial instrument uniquely suited for smaller businesses to enable them to have greater access to sources of external capital. Firms will be permitted to deduct from taxable income previously agreed-upon earnings distributions and investors would treat these as capital gains rather than ordinary income.

Five, the investment tax credit for used equipment. Presently the 10-percent credit applies only up to $100,000 worth of used equipment investment. These should be increased to no less than $250,000 and could be programed to increase to $500,000 by 1985.

Last, cost accounting for small business. Inflation has the effect of reducing the correspondence between cost of goods sold and actual replacement cost, particularly for small business. Inventory deductions are far less than inventory replacement cost and the difference shows up as taxable earnings. We must develop appropriate legislation to permit small business to make timely deductions for inventory costs.

Finally, Mr. Chairman, I wish to add to my list an item not aimed solely at small business, but which could be enormously beneficial to it. The employee stock option plan proposed in S. 360 and originally developed by the Senator from Oregon.

This plan would offer important incentives to employees to exercise stock options, in particular the elimination of tax consequences on the spread between option price and market price and this helps small business attract top management.

On the basis of cost estimates obtained from the Joint Committee on Taxation, I can state this package would cost the Treasury a total of $3 billion in fiscal year 1982.

Mr. Chairman, I have a table from the Joint Tax Committee which contains updated revenue loss estimates of these and other provisions of S. 360 for fiscal year 1982 and the outyears.

Now, Mr. Chairman, I hope that the committee is going to look favorably upon the priorities I have set forth.

In conclusion and I ask that the rest of my statement in its entirety be included in the record. It is this type of investment—we are not talking about spending, we are not talking about general tax deductions, we are talking about investment in the terms of tax reduction.

Just as in the spending category, again, there are different ways we spend our money, it is the investment that I have always supported.

In any event, what I am saying to you is that this type of targeted reduction is going to bring you back more than whatever the immediate outlay is all about. I would hope that the committee would look favorably upon it. If you don't do anything else, include in this tax bill the recognition of the unique role played by small business in this country. It is just not the same as big business.

What is happening is that you are getting a concentration of economic power in the hands of a few because the small businessman does not have access to capital, cannot go ahead and retain capital and, therefore, cannot expand and grow. He has to sell out.

Now never mind any legislation coming forth from the U.S. Senate on who can get together with who and who can merge with who. Competition will take care of this problem if we allow sufficient entries into the contest to compete.

I would hope your bill would be tailored to see that competition continues. Competition in the terms of an active, strong, viable small business community.

Thank you very much, Mr. Chairman.

[News Release]

COMMITTEE ON SMALL BUSINESS, U.S. SENATE—SENATOR LOWELL WEICKER, JR., CHAIRMAN

WASHINGTON.—In testimony before the Senate Finance Committee today, Senator Lowell Weicker Jr. (R-Conn.) Chairman of the Small Business Committee, urged that $3 billion in capital investment tax incentives for small business be included in any tax bill adopted this year.

Weicker made the recommendation as part of testimony on S. 360, the Omnibus Small Business Capital Formation Act of 1981, which he introduced on February 3. The bill is being considered by the Finance Committee as they draft the 1981 tax bill.

Weicker told Finance Committee members that whatever tax bill is reported out, "must be properly tailored to fit the problems and potentials of our economy. I strongly urge the Committee, in the interests of helping to spur economic growth from the supply side, not to overlook small business."

Small business "is really the essence of supply-side economics," Weicker said. "Small business accounts for 90 percent of new private sector jobs, is responsible for 43 percent of the GNP, and produces more than half of all U.S. innovations."

Weicker recommended incorporating the following six provisions into the 1981 tax bill, at an estimated cost of $3 billion: corporate tax rate reduction; capital gains rollover; estate and gift tax reforms; investment tax credits for used equipment; cash accounting; and creation of the Small Business Participating Debenture.

"I believe $3 billion for small business is most appropriate, given its enormous role in the economy," Weicker said. "I have no doubt it will generate in returns to the U.S. Treasury every penny, and more, that is temporarily foregone as a result of tax reduction."

PREPARED STATEMENT OF SENATOR LOWELL WEICKER, JR.

Mr. Chairman and members of the committee, I am very happly to be here today with the ranking minority member of the Senate Small Business Committee, Sena-

tor Nunn, to present testimony on the importance of including capital investment incentives for small business in the tax bill to be considered by this committee and the Congress this year. Senator Nunn and I, along with Senator Durenberger, Senator Packwood, and Senator Baucus of this committee, are coauthors of Senate bill 360, the Omnibus Small Business Capital Formation Act of 1981, which now boasts 25 Senate cosponsors, from both sides of the aisle and from every region of our country. I note also that Senator Bentsen, along with Senators Danforth, Baucus, Mitchell, and Chafee, recently introduced Senate bill 1140, which includes some of the provisions of S. 360.

This committee will have major responsibility for the development of tax law and policy appropriate to our country's needs in this decade. Specifically: to stimulate now-stagnant U.S. productivity; to promote capital investment for the modernization of U.S. industry; to encourage greater personal savings and investment; and generally to spur economic growth from the supply-side—to decelerate rather than accelerate inflation.

I am convinced the President is right when he says we are in the worst economic mess since the Great Depression; but I am deeply concerned that things could get much worse before they get better. I believe there is a potential for an interest rate explosion in 1981 as a too-stimulative demand-side fiscal policy collides with a restrictive monetary policy and a major credit crunch ensues. I do not, as yet, see any sign that the inflationary spiral that has been gathering momentum since 1976 is about to recede. We could very well experience a high-speed stall, a high-inflation, high-interest burnout, precipating a serve recession lasting into 1982.

This is why I believe there is such a grave responsibility on the members of this committee to write a tax bill that is properly tailored to fit the problems and potentials of our economy. There is a rare chance to correct the high-spending, low-investment imbalances that have plagued the economy for a decade or more, but the risk of fanning the flames of inflation is enormous. The economy is very brittle right now, and a grievous error in policy in 1981 could flaw the system for the rest of the decade. Like the Vietnam buildup period of 1965, 1981 could be the watershed year for the U.S. economy for 15 to 20 years.

For these reasons, Mr. Chairman, I have consistently expressed my opposition to enactment of the huge, 30-percent, across-the-board personal income tax rate cut. In my judgment, this is not the time for such economic experimentation.

But, where there is risk, there is also opportunity. Our generation, in this Congress, can chart a new and vigorous course for our country—and we can begin to reverse an era of stagflation—of stagnation with inflation—if only we will have wisdom and discernment and resolve. In the area of tax policy, perhaps more so than in any other, we will need these qualities.

The tax bill reported by this committee must be right; it must be based not on good intentions but on a clear sense of where we are and have been, and where we must go, and how, in this decade. Tax reduction should be linked to achieved Federal spending reduction, and within this limited framework—about $40 billion—it should be targeted to capital investment, saving and job creation.

In this connection, Mr. Chairman, I am here today to seek consideration of our recommendations for investment incentives for small business. The priorities I am about to lay before the committee meet the fundamental test I believe all tax proposals must meet for this bill: They are supply-side tax incentives for capital investment and productivity. Approval of these priority measures by the Finance Committee will enable one of the most productive sectors of the American economy to participate fully in our Nation's economic recovery program.

The record is clear that small business is really the essence of supply-side economics: Small business accounts for 90 percent of the new private sector jobs; small business is responsible for 43 percent of the gross national product; and small businesses, according to the National Science Foundation, produce 4 times more innovations than medium-sized companies and 24 times more innovations than large companies, for every research and development dollar.

The White House conference on small business, held in 1980, estimated that at projected labor force rates, the U.S. will need 11.8 million new jobs in the 1980's to accommodate net increases in the work force. If the hiring contributions of Government and large companies continue at present levels, which is unlikely, about 9 million new jobs will have to come from small business, an average of almost 1 million a year.

To accomplish this hiring requirement, the White House conference concluded that small business would need three things: (1) More external capital, (2) greater retained earnings, and (3) better management.

I am here today to suggest a number of ways that tax incentives can answer these needs and unleash the tremendous productivity of small business.

As the administration bill now stands, small business would not be afforded sufficient opportunity or incentive to contribute fully in the planned U.S. economic revival. The 10-5-3 proposal is good so far as it goes, but it is aimed primarily at the larger capital-intensive firms which invest in longer lived assets, and thus does not really hit the small business sector—which tends to be somewhat more labor intensive and in corporate tax brackets where the benefit of depreciation deductions is relatively small.

I am not saying reject 10-5-3. Indeed, the "5-3" portion of 10-5-3 was a big part of S. 360, and I am still a strong supporter of simplified and accelerated depreciation as a priority item for small business. But, I am saying supplement 10-5-3—or whatever depreciation regime you adopt—with specific small-business-oriented tax incentives.

On the basis of hearings held by the Small Business Committee on this subject on March 9, 1981, and a prodigious amount of committee work in considering the various proposals included in S. 360, I am prepared to recommend the following priorities for capital investment and productivity-boosting tax incentives for small business. You will note that I list these priorities generically, because I understand that the committee will need to fill in the details based on revenue and other considerations:

(1) Further graduation and reduction of corporate income tax rates and an increase in the surtax exemption. This has been a principal element of every major small business tax bill in 1981 and is strongly supported by most small business associations.

(2) Capital gains "rollover."—Permitting an individual to sell an interest in a small business and defer any tax consequences so long as the proceeds are reinvested in another small business within a certain period of time.

(3) Estate and gift tax reforms.—Certain changes are necessary to relieve the heavy burden of estate taxes upon the continuity of small business, especially the estate tax exemption (presently $150,000) and the marital deduction.

(4) Small business participating debenture.—A new financial instrument, uniquely suited for smaller businesses, to enable them to have greater access to sources of external capital. Firms would be permitted to deduct from taxable income previously agreed-upon earnings distributions and investors would treat these as capital gains rather than ordinary income.

(5) Investment tax credit for used equipment.—Presently, 10 percent credit applies only up to $100,000 worth of used equipment investment. This should be increased to no less than $250,000 and could be programed to increase to $500,000 by 1985.

(6) Cash accounting for small business.—Inflation has the effect of reducing the correspondence between "cost of goods sold" and actual replacement costs, particularly for small business. Inventory deductions are far less than inventory replacement costs, and the difference shows up as taxable "earnings." We must develop appropriate legislation to permit small business to make timely deductions for inventory costs.

Finally, Mr. Chairman, I wish to add to my list an item not aimed solely at small business, but which could be enormously beneficial to it: The employee stock option plan proposed in S. 360, and originally developed by the Senator from Oregon. This plan would offer important incentives to employees to exercise stock options, in particular the elimination of tax consequences on the spread between option price and market price, and thus help small business attract top management.

On the basis of cost estimates obtained from the Joint Committee on Taxation, I can state that this package would cost the Treasury a total of $3 billion in fiscal year 1982. Mr. Chairman, I have a table from Joint Tax Committee which contains updated revenue loss estimates of these and other provisions of S. 360 for fiscal year 1982 and out years.

Mr. Chairman, I hope the committee will look favorably upon the priorities I have set forth. There is strong regional and small business organizational support for these proposals, and our country needs and deserves the contribution that small business is prepared to make in terms of capital investment and new job creation. I strongly urge the committee, in the interests of helping to spur economic growth from the supply-side, not to overlook small business. In my judgment, not less than $3 billion of the 1981 tax bill ought to be designated specifically for small business tax inventives. And, if the committee decides to adopt our first priority, the corporate rate reduction and graduation measure—which, incidentally, was the top priority of the White House conference on small business—I am sure you realize that the associated revenue loss would be attributed to firms of all sizes, even though its benefit would be most specifically felt by smaller firms. So $3 billion for small business is most appropriate, given its enormous role in our economy.

Finally, I would remind the committee, and I am aware of the overturn of November 1980, that several of the recommendations I put forward today were included in H.R. 5829, the tax bill reported by the committee last year, which the President-elect stated he could support. I do believe, therefore, that what I have recommended is entirely consistent with the President's overall approach and with the action of the commitee in approving the tax bill last year.

And, so, Mr. Chairman, I hope you will be able to find room in this tax bill for the one sector of our economy that is unequivocally supply-side in nature, and which will surely generate in returns to the U.S. Treasury every penny, and more, that is temporarily foregone as a result of tax reduction.

The Small Business Committee staff and I look forward to working cooperatively with you and your staff in developing a truly balanced tax reduction/capital investment bill for our economy for the decade of the eighties.

Thank you very much.

The CHAIRMAN. Senator Nunn.

STATEMENT OF HON. SAM NUNN, U.S. SENATOR, STATE OF GEORGIA

Senator NUNN. Mr. Chairman, I want to echo what Senator Weicker said. I am going to try to avoid duplicating his remarks. I fully endorse his remarks. I think he has hit the nail on the head. I do not believe we can wait for a second tax bill, because if we wait for that we will be waiting at least for another year, perhaps 2 years. I don't think the small business community can last that long.

I know that Senator Packwood and Senator Durenberger have already cosponsored this S. 360. I have also talked to Senator Long at length about some of my ideas and his ideas on the overall tax bill.

I am delighted to have a chance to testify here today. I will try to make a very brief summary of my remarks.

Several months ago, the administration submitted a comprehensive economic package to Congress calling for a reduced rate of growth in Federal spending and a reduction of Government activity in credit markets, a multiyear tax cut and cost-effective regulations.

I support the general direction of the President's program because it takes the critical major step of shifting stimulus for economic growth from the public sector to the private sector. This is an essential adjustment for the future balance of economic growth, but I do believe Congress needs to adjust and modify the administration's tax proposals.

We need to embark on a policy path away from increased Government spending toward more business investment which is exactly what Senator Weicker just said.

Simultaneously, we need to embark on a path which induces consumers to save more and to spend less for purely consumer items.

Increasing the level of savings, the first step in the process of capital accumulation for productive investment, must be an equal partner with efforts to improve capital formation and retention as we seek the formula to remedy the ills of our economy.

The President's proposal can be improved in several important ways. First, small business needs to be provided with a larger share of the tax cut than the administration proposes, so that needed investment in plants and equipment can get underway in earnest.

Small businesses which provide over 80 percent of the new jobs in the economy need to have specific capital formation and retention tax provisions targeted to its needs so that the small business community can fully participate in the economic recovery.

Second, I firmly believe that additional incentives for middle income taxpayers to increase savings must be put in place in conjunction with a multiyear tax cut. Such incentives will help provide the guarantee that reduced taxes in future years will result in increased savings and I think everyone agrees that that is an essential part of the program.

I support a multiyear tax cut, but I also believe tax decreases in future years should be contingent upon further reductions in Federal spending.

We have identified the first year of spending cuts, but no one has identified the second and third year and you are about to pass a multi-year tax bill. If you follow the President's economic prescription without having any assurance that Congress in the future or even the administration, for that matter, is going to be willing to bite those bullets that are going to be necessary and very unpleasant in the second and third year you will increase rather than decrease inflation.

I don't have a magic formula for a contingency, but as this committee knows, I did have a contingency plan about 2½ or 3 years ago and I know the committee fought hard in conference and had to give it up, but it did pass the Senate and I do think something like that can be of great help in insuring that we have the fiscal discipline necessary to go with the overall tax cut program.

Finally, I believe we need to reduce the Federal deficit and Federal borrowing more rapidly than the President has projected, even if that means reducing the size of the tax cut or spreading it over more years. Those deficits have got to come down at a more rapid rate then the administration proposals.

Each of these factors, the level of savings, taxes, Federal spending, and the deficit, are critical to small businesses because individually and through their interaction they directly affect the level of interest rates and inflation.

It is this two-edged sword of inflation and interest rates that is having a devastating effect on small businesses and in my State the small businesses and the farming community are the very heart of our economy. I think that is generally true in a lot of States in our country.

Of the two evils, the most damaging to my constituents is the interest rates. To thousands of small businessmen and farmers in Georgia, a 10-percent tax cut will be irrelevant if we continue to have 20-percent interest rates because they are not going to have any taxes to pay. The simple reason for that is they cannot make money when you have 20-percent prime rates.

So, what I am saying to the committee is that in any tax bill I think the major considerations should be given to the effect that tax bill will have on interest rates in the short run because for many people that I know in small businesses and farming there is going to be no long run unless the interest rates come down.

I will just summarize S. 360 in terms of the provisions I think are particularly important. The corporate rate reduction, I think, is important. Senator Weicker has already explained that. The accelerated and simplified depreciation, I am very much in favor of that, but I believe this committee needs to carefully look at the precise formula to make sure we don't have some of the inequities that have been recently pointed out in the news media regarding 10-5-3.

I don't have the answer to that. I did spend a couple of hours with Professor Jorgenson, I believe is his name, from Harvard, who has some unique ideas that I wish had been further explored and I would certainly commend those ideas to the committee in looking for an accelerated depreciation formula.

Estate tax reform. I don't know of anything more important to small businesses in America than estate tax reform. We literally are not allowing small businesses to continue. The large businesses in our country have continuity, but the small businesses get wrecked with estate tax. I thoroughly and completely support the provision in S. 360 that would eliminate estate tax when there is a surviving spouse until the second generation tax is employed and would also increase the exemption, I believe, from $175,000 to $600,000.

Next, increase the used qualified property tax credit from $100,000 to $250,000, increase the minimum accumulated earnings credit from $150,000 to $300,000, reinstitution of incentive stock option provisions. The capital gains rollover is an important provision of S. 360. Inventory accounting changes are also important.

Not incorporated in S. 360, but while I am here I want to give particular emphasis to proposals that Senator Long has been the champion of for a long time on the employee stock option plans. I believe that improvement can be made in that area. I will be following his lead in that because he really has, I think, a unique idea in trying to share the equity in America and give more people a vital stake in our free enterprise system.

I also want to endorse, Mr. Chairman, Senator Chafee's bill which greatly expands the IRA accounts. I think that may be one bill which should assume a real priority in trying to find savings incentives. I have coauthored that bill. I am sure other people have.

I have also coauthored Senator Boren's bill, Senator Bentsen's bill and I have coauthored almost every bill on savings, not because I think we can pass them all, but because I think that has to be the very heart of any tax incentive program—to increase the incentive for American people, particularly middle income people to save money. If we don't do that, no matter what the tax cuts are they are not going to go in savings, in my opinion.

That is just a country lawyer opinion, but I know something about human nature and a person who has no incentive to save money is not going to save money and that is the case with most middle income Americans today.

Mr. Chairman, I would just ask that the balance of my remarks, for purpose of saving time, be incorporated into the record.

Again, I want to express my strong support for the testimony in more detail on these provisions of Senator Weicker, the chairman of the Small Business Committee.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SAM NUNN

Mr. Chairman, I am pleased to have this opportunity to present my views to the Committee on S. 360, the Omnibus Small Business Capital Formation Act, and small business tax relief.

Several months ago the Administration submitted a comprehensive economic package to Congress calling for a reduced rate of growth in federal spending and a reduction of government activity in credit markets, a mult-year tax cut, and more cost-effective regulations.

I support the general direction of the President's program because it takes the critical major step of shifting stimulus for economic growth from the public sector to the private sector. That is an essential adjustment for the future balance of economic growth. But, Congress needs to adjust and modify the Administrations tax proposals.

We need to embark on a policy path away from increased government spending toward more business investment. Simultaneously, we need to embark on a path which induces consumers to save more and spend less. Increasing the level of savings, the first step in the process of capital accumulation for productive investment, must be an equal partner with efforts to improve capital formation and retention as we seek a formula to revive the economy.

The President's proposal can be improved in several important ways. First, small business needs to be provided with a larger share of the tax cut than the Administration proposes so that needed investment in plant and equipment can get underway in earnest. Small businesses which provide over 80 percent of the new jobs in the economy need to have specific capital formation and retention tax provisions targeted to its needs so that the small business community can fully participate in the economic recovery.

Second, I firmly believe additional incentives for middle income taxpayers to increase savings must be put in place in conjuction with any multi-year tax cut. Such incentives will help provide the guarantee that reduced taxes in future years will result in increased savings.

I support a multi-year tax cut, but I also believe tax decreases in future years should be contingent upon further reductions in federal spending. Such a move would help insure fiscal discipline and a continued reliance on the private sector for economic growth.

Finally, I believe we need to reduce the federal deficit and federal borrowing more rapidly than the President has projected, even if that means reducing the size of the tax cut or spreading it over more years.

Each of these factors—the level of savings, taxes federal spending, and the deficit—is critical to small businesses because individually and through their interaction, they directly effect the level of interest rates and inflation. It is this two-edged sword of inflation and interest rates that is having a devastating affect on small business. Of the two evils, the most damaging to my constituents is interest rates. To thousands of small businesses and farmers in Georgia, a 10 percent tax cut be irrelevant if we continue with 20 percent interest rates. They will owe no taxes because they will be bankrupt.

To provide small business tax relief to attack these twin evils, I urge the Committee to adopt several provisions from S. 360 which would assist small firms with their capital retention and formation efforts, and with improved business continuity. The Committee recognized the importance of several of these proposals and included them in the tax bill reported last year.

CORPORATE RATE REDUCTION

The number one recommendation of the White House Conference on Small Business and a top priority of witnesses testifying before the Small Business Committee, the reduction of corporate tax rates. Reducing corporate taxes is the fairest, most direct means of permitting small business to retain the internally-generated capital necessary for productive investment in new plant and equipment. Reducing corporate taxes and further graduating those taxes by broadening and increasing the number of brackets is an important step in providing small concerns with targeted tax relief.

ACCELERATED AND SIMPLIFIED DEPRECIATION

Soaring inflation has too often made the timing of deductions, even when coupled with the investment credit, inadequate to reflect recovery of the original cost of an asset. This factor is seriously impairing the ability of business to finance the replacement of obsolete plant and equipment. It is important that a new accelerated and simplified depreciation system be adopted which is neutral and will lead to an efficient allocation of resources. Faster cost recovery would do no more than anything else as a general revitalizer of the business continuity. I am not wedded to a particular formula here.

ESTATE TAX REFORM

Estate taxes were originally conceived to prevent huge aggregations of wealth that could have adverse affects on society. But the estate tax law of today seriously imperils the transfer of family businesses and farms from one generation to the next. In some instances, current estate tax law actually promotes sellouts to larger corporations for inheritance tax purposes. To correct these problems, S. 360 proposes to: (1) Provide for an unlimited gift and estate tax marital deduction so that an entire estate can be passed on tax-free to a surviving spouse; (2) raise the present estate tax exemption so that up to $600,000 of an estate can be passed on tax-free to a decedent's children; and (3) increase the annual gift tax exclusion to $6,000.

Since 1970, the average value of an operating farm in Georgia has increased by more than 230 percent. The average value of an acre of farmland in the State has increased by nearly 300 percent. Similar increases in the values of small businesses and homes throughout the nation has taken place.

Inflation is artifically distorting the value of estates by making them appear more and more valuable while taxes in turn are taking away a bigger and bigger piece of the estate. Estate tax law should be revised to compensate for this.

(4) Increase the used qualified propoerty tax credit ceiling from $100,000 to $250,000 so that small businesses, which often acquire significant amounts of used property, can better participate in the general upgrading of productive facilities.

(5) Increase the minimum accumulated earnings credit from $150,000 to $300,000. Increased borrowing costs caused by stiflingly high interest rates has made small concerns rely more heavily upon the internal generation of capital for future needs. An increase in the credit not only adjusts for the rise in inflation but would also help reduce borrowing pressures.

(6) Reinstitution of an incentive stock option provision so that small concens can attract new management and retain the services of executives who might otherwise leave.

(7) Capital gains "rollover" so that that tax on the proceeds from the sale of a small business are deferred if they are reinvested in another small business within 18 months. And,

(8) Inventory accounting changes, including allowing firms with less than $1 million in sales to take an immediate deduction for the current value of their inventory, and allowing taxes due from shifting from "FIFO" accounting to "LIFO" accounting to be paid over a 10 year period instead of in one lump sum in the first year.

There are other provisions in S. 360, such as the proposed increase in the number of permissible Subchapter S shareholders and the Small Business Participating Debentures which would assist small-businesses in their capital formation efforts and which deserve consideration by the Committee.

Mr. Chairman, a weakness of the 10 percent across the board tax cut plan is that it gambles that middle-income Americans will save more. I believe by taking a rifle rather than a shotgun approach and adopting specific new incentives for savings such as increased exemptions for savings and expanded IRA's, we can reduce the gamble and direct middle-income dollars into savings and investment.

Earlier this month, Senator Chafee held hearings on savings incentives such as that proposed in S. 819, the Savings Incentive Act, Senator Boren in S. 1072, the Residential Housing Tax Incentive Act, Senator Bentsen in S. 701, the Home Mortgage Incentive Act, and Senator Chafee in S. 243, the Savings and Retirement Income Incentive Act. Enactment of these types of measures would help reverse the "buy now, save later" philosophy by helping to make the tax code more neutral in its treatment of savings and consumption. They would help reduce demand-side inflation, provide a basis for the improvement in the capability and efficiency of the supply-side of the economy, and thus lead to lower interest rates and a reduction of inflation. Small businesses would directly benefit from these actions.

Mr. Chairman, since 1975 Congress has enacted $2 billion of small business tax cuts and the nation has reaped tremendous benefits. For example, small concerns

have since created more than 12½ million new jobs. I am confident that if small business receives a fair share of this year's tax bill, and if that bill helps provide a basis for lower interest rates and more savings, small business will make a similarly strong contribution to our nation's economic recovery.

Again, I appreciate the opportunity to express my views to the Committee on small business tax relief. I encourage the Committee to act expeditiously on small business tax legislation and would be pleased to answer your questions.

ESTIMATED REVENUE EFFECTS OF OMNIBUS SMALL BUSINESS CAPITAL FORMATION ACT OF 1981 (S. 360)

[In millions of dollars]

	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Title I—Income taxation:						
Subtitle A—Capital formation:						
Sec. 101. Allowance of credit for investment in certain new issues	(5)	-12	-18	-19	-21	-24
Sec. 102. Small business participating debentures		-183	-571	-1,254	-2,172	-3,349
Sec. 103. Reduction in taxes on capital gains	(1)	(1)	(1)	(1)	(1)	(1)
Sec. 104. Nonrecognition of gain of certain proceeds from the sale of incentive stock	(1)	(1)	(1)	(1)	(1)	(1)
Sec. 105. Increase in number of subchapter S shareholders	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 106. Reserves for marketmaking activities	-46	-87	-64	-37	-22	-14
Subtitle B—Capital retention:						
Sec. 111. Corporate rate reductions:						
Change in top rate	-778	-2,591	-3,836	-4,277	-4,768	-5,317
Change in other rates	-349	-1,025	-1,400	-1,502	-1,618	-1,744
Sec. 112. Capital cost recovery allowance	-1,765	-12,020	-20,826	-31,567	-42,639	-52,315
Sec. 113. Increase in accumulated earnings credit	-13	-38	-42	-45	-50	-55
Sec. 114. Increase in used equipment eligible for investment tax credit	-102	-240	-276	-301	-315	-329
Subtitle C—Employee stock options:						
Sec. 121. Incentive stock options	(3)	(3)	(3)	(3)	15	30
Subtitle D—Inventory accounting for small business:						
Sec. 131. Cash accounting for certain small businesses		-997	-2,202	-2,257	-2,431	-2,624
Sec. 132. 10-year averaging permitted for increases in inventory value required for adoption of LIFO method	-284	-764	-775	-551	-347	-273
Sec. 133. Application of revenue ruling 80-60	[4] -160					
Title II—Estate and gift taxes:						
Sec. 201. Increase in unified credit			-1,474	-2,588	-3,546	-4,582
Sec. 202. Unlimited marital deduction			-125	-125	-125	-125
Sec. 203. Increase in annual gift tax exclusion		-60	-60	-60	-60	-60
Sec. 204. Valuation of certain property		-300	-300	-300	-300	-300
Sec. 205. Estate tax treatment of transfers made within 3 years of decedent's death		-40	-45	-50	-55	-60

[1] Not yet available.
[2] It is not possible to quantify the revenue loss from this provision with any degree of accuracy, but it could be subtantial.
[3] Loss of less than $5 million.
[4] A comparable gain in later years, primarily 1990-91.
[5] Negative.

The CHAIRMAN. Well, let me say first of all that the entire statements will be made a part of the record and I wish to commend both of my colleagues for their excellent statements. A number of these suggestions are under active consideration by the committee, by members of the committee and are being analyzed by the Joint Tax Committee and by our own staff.

Do I understand correctly that you both favor a multiyear tax reduction proposal without getting into specifics?

Senator NUNN. I can say I do. I think the multiyear approach is needed for long-range planning. I have felt that way for several years. I do believe we need to find some way to make Congress aware of the necessity to have a corresponding spending reduction in the second and third year.

We can't have a 3-year tax reduction and a 1-year spending reduction. There has to be some contingency on those outyears, I think.

The CHAIRMAN. Senator Weicker.

Senator WEICKER. Yes, I would very definitely support a multiyear approach, but I want to make it clear, not in the sense of the 10-10-10. But, in concept as to having a multiyear tax reform package rather than 1 year, I support aspect.

The CHAIRMAN. Right. You both commented on the possibilities not waiting for a second proposal. Apparently, you feel that there may not be a second bill. Is that right?

Senator WEICKER. I have not the slightest doubt.

The CHAIRMAN. There could be a second one, but it might not go anywhere, I guess. That is another option.

Senator WEICKER. I have a feeling that you are going to labor mightily and come forth with something very worthwhile and then people are going to focus their attention on other matters here in the Congress.

I think the spotlight is on your committee. It is on the subject and I think you know as well as I do that it is not going to continue for 2 to 3 years. That is the reason I am hoping you will cooperate in this package.

Mr. Chairman, let me say right now that I just don't see how when we started off with a $63 billion deficit, we are going to have $87 billion in additional defense spending in the next couple of years and a proposed $240 billion cut in the individual income tax. Just in terms of economics, I don't see how this is all going to come together in the terms of a balanced budget.

I think you can target. For instance, the cost of the package I presented to you is $3 billion, not $54 billion. It is not even $40, but it is $3 billion, but as I say you are going to get back a great deal from it and that is the reason why I speak for this type of tax reduction rather than the rather simplistic one which might be easy to understand, but is not going to produce the result desired.

Senator NUNN. Mr. Chairman, my view on that question is I don't see how the Finance Committee can be in two places at one time. I know you are going to be tied up most of this year either on this bill or in conference and I do not see how you can have a second tax bill unless you are willing to share your jurisdiction with some other committee that can be marking up that second bill while you are in conference on the first.

The CHAIRMAN. We already share too much with the Budget Committee.

In fact, I waited 20 years to be chairman and I found myself to be a subcommittee chairman.

But, I would say this, there seems to be a little more interest in maybe a two-phased approach and some support for that. I can

assure both of my colleagues that if in fact that should happen, that there would be some insurance built into the second package to make certain that it wasn't overtaken by the first and never heard from again.

I think there are things we could do to make certain that those who had an interest in, not only the things you suggest, but many other worthwhile proposals—whether it is marriage penalty or income earned abroad—a number of options have been presented. I think we could probably work that out. Don't lose confidence in the committee yet.

Senator NUNN. Mr. Chairman, I have great confidence in this committee. I think you have the best tax experts on this committee anywhere in Congress and I know you will have a good bill.

I would urge one other thing. This has nothing to do with small business, but our way of handling tax bills and appropriation bills on the floor has really got to be reviewed. There has to be a revenue loss set at the beginning of that debate.

If we go in there with a tax bill that starts with $40 billion and we end up with a tax cut that ends up with $70 billion, even if it happens to be right, nobody in the country has any real reason to be confident that economic planning has been the heart of the tax bill.

They see us go on the floor with a $40 billion bill and it ends up at $80 billion and that is what causes a tremendous loss of confidence. I think there has to be an all-out effort to establish at the very beginning of the debate on the floor, and the committee could find a way to do this, as to what the Senate is going to have as a revenue loss and make the Senate vote on that and then make any tax proposals compete against each other for that revenue loss.

Otherwise, we look like we are out of control. In fact, we are out of control if we have a bill that doubles in revenue loss without any kind of economic philosophy behind it.

Senator WEICKER. One last comment also, Mr. Chairman, in relation to the possibility of a second tax bill being the vehicle by which small business stands to benefit.

The field is already littered with the bodies of small business. They are just going belly-up right now and in increasing numbers. I don't think they can afford to wait another year.

Indeed, I don't see anything that is going to bring interest rates down during that period of time. I would say there is a certain element of urgency insofar as their particular plight is concerned.

The CHAIRMAN. We wouldn't intend to wait another year. We intend to do everything about the same time. Under the early bird rule, Senator Packwood.

Senator PACKWOOD. I have no questions.

The CHAIRMAN. Senator Long.

Senator LONG. Thank you, Mr. Chairman. You know if I had my way we would be talking about the second bill now. You know we reported out the first bill last year. Maybe you recall Bob Dole had the tax cut bill. He offered it on a debt limit bill, and we met in the Democratic caucus. We felt we could not vote for the Dole amendment. It had to be considered. We had to think about the matter and to have more opportunity to amend it. That was a year ago.

Mind you now, the tax cut bill is still kicking around even though this committee has been doing all it could. I fought and voted that Senator Dole try to move it on the Senate floor. Senator Dole even got Ronald Reagan to endorse it while he was a candidate for President.

After he had been elected President, even with Ronald Reagan pushing for it, we still couldn't get it through. It still hasn't been passed, even with Ronald Reagan pushing for it.

Now we are told to go ahead and pass this one bill with the President pushing with everything he has, during the honeymoon period he has with the Congress. After you get through with this one bill you fellows are on, then you are on your own. You are welcome to pass another bill.

Do you think that that other bill is going to have the same priority? Here are 100 Senators all waiting with their amendments, and 435 Congressmen are all waiting with theirs.

How much can they allow us for the second bill? You said, Senator Nunn, that there ought to be some limit on how much the second bill can have. How much can they permit us to have?

If they are going to accommodate 535 Members of Congress, there will have to be about another $50 billion to take care of all of these amendments.

We have had a lot of trouble passing this bill—we are not talking about a House-passed bill, we are talking about a Senate bill. The House has not even acted on the first bill.

You talked about 6 months to a year or a year and a half, and that is about the timing on this bill, from the time we first started on it until it will become law the way it is going now.

Anybody who is in real trouble and needs some help had better try to get aboard this bill, because the next one might be long delayed. By the time it gets through it might be loaded down like a bullfrog full of buckshot who can't seem to quite get off the ground.

Your problems can be met, Senator. I think we ought to put an amendment on this bill, even when it comes out of the committee, like the one I have usually offered at the end of the process. By the time the Senate gets through loading a bill down with costly amendments, they want us to come back from conference with not more than *x* amount in the bill.

On that basis, if you add something to the bill, everybody understands that it has to squeeze out something somewhere else. I think you would give people offering an amendment the best shot to have it considered. That way they don't have to knock out some particular amendment in order to get theirs in. When we go to conference, we have to squeeze the genie back inside the bottle, and each one of these amendments can be considered.

The small business amendment can be considered along side some of the others. But basically, you have to say that if this stays in the bill, then some of this other provision has to go out.

Senator NUNN. Well, Mr. Chairman, let me just comment on that.

If we don't have any other way of doing it, I would certainly endorse that way. But, what that really does is delegate to the conference the priorities on taxation instead of having the Senate make its own decision.

Back in the Georgia Legislature, we didn't do everything right but we used to have a procedure where you set the overall revenue loss to begin with and then every amendment had to compete against every other amendment. It is not that complicated. It would be to begin with. It would be very difficult. Maybe it can't be done this year, but the Senate itself ought to set these priorities rather than having the conference committee.

I will certainly repeat my initial statement. If the Senate cannot find a way to do that because of the importance of this discipline then I would rather the conference committee do it than nobody do it.

Senator LONG. Well, the conference committee has to do that with regard to just the ordinary Senate amendment. The House is going to use up everything they think the budget can stand by way of a tax cut.

We will not have that choice. When we add things in the Senate, some of which you are advocating right here, all that is subject to being dumped in conference because the House might insist on standing by their figures. If they do, then some of your help for small business would have to go by the wayside.

We have been reasonably successful in getting the House to accept the best of the Senate amendments and of course, if the House puts a lower priority on an amendment, you can understand how that might not fare too well in conference.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman.

I want to compliment the former chairman on his recitation of history in putting all of what we are doing in perspective. As I recall, he came into that process with a resolution signed by 48 Democrats that said you will pass a tax bill and so he pulled out a tax bill in about 2 weeks out of a bipartisan committee and then after that got done he went right back to his colleagues and said here are your marching orders, now let's get this thing up and over with and somewhere along the line they pulled the rug out from under him.

I think he is absolutely right. I think we are dealing with a second bill here. That was a tremendous first effort. It hit at all the important things and from the standpoint of the two panelists here who have taken the leadership in the small business area, it had much of what is in 360 or at least, a lot of 360 was incorporated into that legislation. It is all relative.

Small business is not that much different from other businesses, but there is an awful lot of unincorporated families and unincorporated individuals practicing in that area that are overlooked in 10-5-3, but given a lot of consideration in 360 and estate tax and a variety of those other proposals.

I am pleased to be a principal cosponsor of 360 and I just hope, Mr. Chairman, that we follow the same basic course that we followed last year in this committee and take a comprehensive look at all the elements that make this economy work when we address ourselves to these tax issues.

I thank these two people for their leadership in this area.

The CHAIRMAN. I think that I might add there is one basic difference. We have a President now who wants a tax cut. We had

one then who didn't want a tax cut. That does make a difference. He is a Republican. He has some influence with a lot of us on both sides of the aisle, but I certainly share the view that we had a good product last year.

Senator LONG. If I might inject, the other one had enough influence to keep us from passing a tax cut.

The CHAIRMAN. Right. That is about all he had.

Senator Symms?

Senator SYMMS. Thank you very much, Mr. Chairman. I will just ask one question. I welcome my two colleagues here this morning.

In this overall tax package with respect to both of your interest in small business, where do you put this estate and gift tax reform or repeal on the list of priorities?

Senator WEICKER. I put it fairly high up, Senator. I believe that out of the small business conference it almost was at the top of the list for those that are involved with small business. It was at the top of their list of priorities and I put it, I would say, in probably the second spot next to the——

Senator SYMMS. What do you recommend? We start phasing in pointing toward an outright repeal eventually of the estate and gift tax over a long period of time or just outright repeal it immediately?

Senator WEICKER. No. I think on any of these items they ought to be phased in. I think we have to come to grips with the problem. I don't want any small business owner, because of the estate tax problem, to be forced to sell his business to a larger corporation. At least he should have that option.

I am not saying that that option shouldn't be available to him, but right now you are forcing small businesses to merge with large as the family situation changes.

Let me tell you, whether it is this. Whether it is the estate problem which you have mentioned or whether it is a matter of capital, the large businesses are surviving this economic crunch. They have the capital. They can pay the interest rate. They don't like it, but they are surviving.

The smaller ones are being forced for the estate problems that are raised and because they can't get capital or they can't pay the 20-percent interest rate.

Then we come along as we see this concentration of economic power and we get a Kennedy-Metzenbaum type of bill which says who can get together with who, et cetra, by legislative fiat.

I am saying to you that that problem—I would just as soon have that problem resolved within the private sector by the element of competition. But, there is no competition now by virtue of the economic policies. People are either forced to sell out for the estate tax reasons or because they can't get capital or they can't pay that interest rate.

That is at the bottom line of what it is we are trying to do in this targeted tax relief.

Senator SYMMS. Thank you. I might just say that Senator Boren and I had one day of hearings here and we have some more scheduled and we would be happy to have both of you at least submit testimony on behalf of the interests of small business.

There certainly is some major support, I think, for some major changes in this obnoxious death tax that we have that is absolutely forcing small business to sell so they can liquidate the estate to pay off the estate tax. It causes a centralization of business in bigger and bigger hands all the time.

Senator NUNN. Senator Symms, I might say, I have a very high priority. I haven't tried to assign. I would say, savings incentives is number one and estate tax is probably almost a second or close to that.

I believe it is having an opposite effect of what it was intended to do. It was intended to prevent the huge accumulation of wealth in America that would be passed on from generation to generation. What it is doing now, as you have already observed, is requiring small businesses to sell out and it is in effect making an accumulation of larger corporations and businesses rather than smaller.

I have not thought through whether I would favor the total repeal of it or not. I am not prepared to make that step now, but I do favor some great relief coming in the very near future.

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

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. I want to commend Senators Weicker and Nunn for their leadership in the area of concern for small business in tax matters.

I wanted to ask Senator Weicker a question. I wasn't here when you gave your oral statement, but I have looked at your written statement and I notice you have concern for cash accounting for small business.

Recent studies indicate that inadequate inventory accounting overstates income even more than inadequate depreciation and yet the Administration's program is oriented almost entirely toward depreciation.

In terms of small business, Senator Weicker, do you consider this to be an important matter. I address not only the question of cash accounting, but also the inordinately complicated regulations that make it impossible for most small businesses to use the last in, first out inventory accounting procedure. This results in a very dramatic overstatement of income for small business.

Do you regard those as important matters, Senator Weicker? I would appreciate your comment on that.

Senator WEICKER. Again, here I think that on the basis of the opinions of the small businesses themselves they would probably rank this about No. 3. It is high on their list. It is a relatively small matter from the point of view of income loss.

I really can't—again, it is a matter which would bring enormous relief to the small businesses with a small loss of revenue. I know in the minds of small business, it ranks very much at the top of the list.

Senator MITCHELL. Senator Nunn, you just said that you felt savings incentive was the No. 1 priority item. Would you indicate specifically what savings incentive you feel should be adopted. What are the most important ones from your standpoint.

Senator NUNN. Well, I have either sponsored or cosponsored almost everyone that has come in the Senate. I think that indicates

my commitment, but also my lack of being able to say which ones will work better at this time.

I think that is a real job and a challenge for the Finance Committee. I happen to believe the Chafee bill with the IRA account expansion giving everyone a chance to participate in that even if they are already on a pension plan is enormously important.

It increases the amount of it. It also converts that IRA from simply a retirement account to also a savings account. It allows withdrawal without penalty for the purpose of buying a home or for the purpose of educating one's children. I think that gets to middle income America. They simply can't see their way to lock up money until they are aged 60 without having any kind of a review period.

I would say that one makes a lot of sense. The Bentsen bill which gives a real break for people who put money long term into institutions that make real estate investments, I think is a good bill. The Boren bill is a good bill. It has been sponsored on the House side by Ed Jenkins, Congressman from Georgia.

I have a bill in that would allow the exclusion from gross income of 10 percent the first year, 20 percent the second, 30 percent the third of interest and dividends.

I think that warrants your attention, but I believe you are going to have some real expert advice about which ones of these will produce the biggest bang for the buck so to speak.

I just again repeat that I think giving an incentive to middle-income America to save money has to be the top priority in this tax bill.

Senator MITCHELL. Thank you, Senator. I have no further questions.

The CHAIRMAN. Thank you very much. We hope to have you back when we take up social security again.

Is Congressman Rousselot in the room?

Well while he is on his way we will hear Mr. Kirkland, President of the American Federation of Labor.

Welcome, Mr. Kirkland. We will be pleased to hear your statement. You may identify those who accompany you.

STATEMENT OF LANE KIRKLAND, PRESIDENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY RAY DENNISON AND RUDY OSWALD

Mr. KIRKLAND. Thank you, Mr. Chairman. My name is Lane Kirkland. I am president of the AFL-CIO. I have with me, today, Ray Dennison, director of legislation and Rudy Oswald, director of research.

By your leave, Mr. Chairman, I will just summarize my statement and offer the brief statement for the record.

Mr. Chairman, the AFL-CIO believes that tax policy can play an integral role in restoring economic health to alleviating the hardship and damage caused by inflation and beginning the long overdue process of rebuilding the Nation's industrial base.

The administration's proposals, however, would not achieve these goals and would risk further inflation, exacerbate fundamental economic weaknesses and waste essential Government revenue.

Instead of the administration's 3-year tax cut proposal what is needed is a carefully defined package of 1-year tax reductions.

These should first equitably restore some of the buying power lost to inflation without causing new inflationary pressures and second, encourage economic growth in those industries and geographic areas characterized by outmoded public and private facilities and high unemployment levels.

We believe that the concept incorporated in H.R. 3218, introduced by Representatives Guarini and Brodhead, would meet these objectives in a fiscally responsible manner.

It is half as costly as the first year of the administration's program, without restricting the flexibility of the Congress in the future to adjust tax policy to economic needs.

By contrast, the administration's program would spur inflationary spending on luxury items and encourage speculation in real estate and commodities that will increase the prices of necessities.

It would contribute to the continued weakness of certain basic industries by dissipating business tax cuts on those industries that already have sufficient cash and market incentives to invest in new plant and equipment.

The assumptions of so-called supply side economics, on which the administration's tax program is based are faulty.

In the first place, venture capital is not languishing. It is available, albeit at excessive interest rates. On the other hand, continued shortfalls in public investment threaten economic recovery.

It is shortsighted to encourage massive new investment in plant and equipment while ignoring the public intrastructure so vital to the economy.

New plants that are not served by sewer and water systems or adequate transportation facilities to ship the increased supplies of goods to markets are useless.

Similarly, there is no evidence that the wealthy will save their tax windfall. There is a plethora of get rich quick schemes and speculative opportunities beckoning to the wealthy from the pages of the Nation's financial journals.

The consumer market serving the well-to-do is not weak; rather, it is booming. Overstimulating that market at the expense of the consumer market serving the bulk of the Nation's wage-earners, which is weak, would further aggravate the imbalance in the economy.

Finally, the business tax cut proposals would largely subsidize investment that would take place anyway because they are not focused on those sectors that, in fact, need new investment.

Such a large increase in cash available to corporations may be used to buy up other companies, heightening inflationary pressures caused by concentration or to finance plant shutdowns and relocations that destroy jobs and blight local communities.

The administration program is presented with a facade of equity for individuals and neutrality for corporations. It is neither.

The bulk of the benefits of the individual tax cut go to those individuals in the highest income brackets—nearly 30 percent to the top 5 percent.

By contrast, the program we support would give 60 percent of the benefit to the vast majority of taxpayers who earn less than $30,000 a year.

It is neither equitable nor fair for the Government to grant almost $17,000 in tax cuts over the next 3 years to an individual earning $100,000 a year, while those earning the median family annual income of $20,000 receive less than $1,500.

By the same token, those corporations with the highest earnings—oil companies, the communications industry and other capital intensive firms—would gain the lion's share of the business tax cuts. Those industries facing the most critical needs, such as autos and steel, would get little benefit.

With persistent high unemployment, the Nation needs jobs. Yet the administration proposal concentrates its benefits on larger, more prosperous, capital intensive firms with little potential to increase employment.

It seems to us a more prudent use of tax dollars to encourage investments that will increase employment opportunities, especially in hard-pressed urban areas.

The 10-5-3 depreciation allowance speed-up is not a program to encourage investment. It is a program to shift the tax burden from corporations onto the backs of individuals.

Given the current state of the American economy, we see absolutely no reason why the Government should reward any company for purchasing equipment from abroad.

Speeding up depreciation allowances on Datsuns would only speed up the deterioration of the American automobile industry.

Because we are also concerned about the consequences of locking the economy into a 3-year tax cut, the AFL-CIO supports a 1-year tax cut. Any further changes should be based on experience, not guesswork.

The alternative we support provides a greater share of tax relief to those low- and middle-income families who need help now. It provides tax relief for smaller, more labor intensive companies ignored by the Reagan proposal. And it targets other business tax incentives to those areas and industries, new and old, that most need help.

This alternative recognizes that tax burdens are too high for many, but not all individuals; that some industries need tax relief, but not all.

Most importantly, it also avoids the economic peril that could result from shackling the country to one set economic approach that, at best, is highly questionable.

Mr. Chairman, the alternative program available to the committee in H.R. 3218 is equitable, fair, workable, and prudent. The administration proposal lacks those essential elements so vital to any tax program.

[The statement follows:]

PREPARED STATEMENT OF LANE KIRKLAND, PRESIDENT AFL-CIO

The AFL-CIO appreciates this opportunity to present its objection to the Administration's tax cut proposals. Since we believe that some tax reduction legislation is in order, we would particularly urge this committee's support for an alternative—H.R. 3218, sponsored by Representatives Frank Guarini and William Brodhead. In sharp contrast to the Administration's program, this bill is fair and fully consistent with America's needs, while not locking the Congress and the country into a three-year

program of tax cuts that would increase inflationary pressures and widen the budget deficit.

The individual income tax cut called for in H.R. 3218 is a refundable credit equal to 20 percent of employee social security payments. The measure is retroactive to January 1, 1981, and the maximum reduction would be $395 for a family with one wage earner and $790 if both husband and wife are working.

The effect of the AFL-CIO supported proposal would be:

Most moderate and middle income taxpayers in the first year would receive as much or more than under the Administration plan. (See attachment 1.)

The 15 million low income workers ignored in the President's program would receive a tax reduction.

The first year cost would be about $16 billion compared with $30 billion for the Administration program.

Taxpayers in the $30,000 and below group would receive 60 percent of the benefits compared with only 40 percent for the same category under the Administration program.

Taxpayers in the $50,000 and over income group would still get 10 percent of the tax cut under our proposal, which is twice their population share. But that is in sharp contrast to the President's proposed 30 percent share for this group.

And, the AFL-CIO supported measure does not lock Congress into a three-year program that would risk continued inflation, huge deficits and unconscionable interest rates.

Equivalent tax reductions are provided to public and railroad employees not covered by Social Security. Employers would receive a 5 percent Social Security tax credit—reducing business taxes by about $4 billion and be of particular benefit to smaller, more labor intensive firms.

The reindustrialization business tax cut alternative in H.R. 3218 would efficiently target funds to the industries and areas where the needs are greatest at minimal cost and risk. It would represent a major beginning toward the revitalization and rehabilitation of this nation's basic industries and economically distressed areas.

Briefly, it calls for the establishment of a tripartite—business, labor and government—Reindustrialization Board. Under this Board, a Reconstruction Finance Corporation (RFC) would be set up to channel public and private funds into reindustrialization projects primarily in areas most in need.

The RFC would have initial authority to allocate $5 billion in tax expenditures and an additional $5 billion in loans, loan guarantees and interest subsidies which, in turn, could leverage a total of $25 billion in private capital. The emphasis would be on basic industries, and allocation decisions would include factors such as eliminating capacity "bottlenecks," helping new U.S. industries with a high growth potential and aiding firms that have difficulty competing because of unfair foreign practices.

Eligibility considerations include reasonable demonstrations that the aid would be used to finance net increases in domestic investment and would be compatible with the local area's development plans and needs. All recipients would have to comply with nondiscrimination provisions of federal civil rights and labor laws.

The funds of the RFC could be augmented by investments from pension plan funds, as well as other sources of private capital, thereby tapping a huge source of funds for new investment. To assure that the interests of the pensioners are protected, the bill provides a government guarantee of the invested funds that are placed in the RFC.

By contrast, the Administration's tax package is grossly unfair and much too costly. It would add to inflation, axaggerate basic economic problems and dissipate funds needed for their resolution.

The facade of even-handedness implied in the 10 percent per year individual income tax cut quickly disappears upon closer inspection.

There is, for example, no tax cut under the Administration's proposal for some 15 million low-income working Americans. Their taxes went up this past January as a result of the Social Security payroll tax increase, and this same group will be among the first to feel the impact of the Administration's budget cuts.

The average worker in the private sector who, according to the Bureau of Labor Statistics, earns about $12,000 a year would receive a first year cut of $128 if single, but only $92 if supporting a family of four.

A family at the national median income of approximately $20,000 would receive $228. At twice the national median ($40,000), the cut amounts to $648—almost three times as much. At $100,000 the cut is $1,840—eight times as much.

This same upside down notion of "equity" is demonstrated in attachment No. 2 which shows that the three-year program amounts to a 9.2 percent increase in after

tax income for the $100,000 a year salary earner compared with 3.4 percent for the $20,000 family and only 1.9 percent for the $12,000 wage earner.

According to the estimates of both the Administration and the Joint Committee on Taxation, nearly 30 percent of the benefits of the Administration's tax cut would go to those with incomes of $50,000 and over—the top 5 percent of the nation's taxpayers. When fully effective, the average annual tax cut for this group would be $5,669. The remaining 95 percent of the population would receive an average reduction of $743.

Mr. Chairman, clearly a scheme which gives so much more to those at the top—in absolute as well as relative terms—cannot be considered fair or even-handed.

The so-called "supply side" notion that such cuts in marginal tax rates will entice more people into the labor force and encourage them to work harder completely ignores the fact that there are nearly eight million Americans looking for work, another four million on part-time schedules because full-time work is not available, and more than one million workers who have dropped out of the labor force because the search for jobs was futile.

Contrary to reality, the Administration's proposal is based on the assumption that workers have full and precise control over their hours and earnings, and that they stop or start work according to the dictates of their marginal tax bracket. I am sure there are some individuals who can hang up the "Gone Fishing" sign at will and those who can choose between a client or a patient and an afternoon of golf. But I also know that few workers enjoy such an opportunity.

The "supply side" theory also presupposes that there is a need for new venture capital and that cutting taxes for the wealthy is the means to that end. Yet the Wall Street Journal (March 18, 1981, page 31) reported that the volume of new capital committed to venture pools in 1980 was almost triple 1979 levels, noting: ". . . there is more than enough venture capital to go around . . ." The Journal quoted one analyst as stating: "There's so much money chasing these deals that venture capitalists are in competition with each other."

Another key flaw in the theory is the likelihood that the inequitable redistribution of income produced by the Administration's tax cuts will actually result in lower levels of savings and investment. The level of savings consists of both government saving and private saving. If the Administration's tax cuts are to result in any increases in national saving, the losses to the government must be more than offset by increases in private savings. The Congressional Budget Office and many others have presented evidence demonstrating that private saving does not respond in such a fashion, and there could be a net decline in national saving if the Administration's tax cuts were enacted. And, of course, this contributes to higher interest rates and diminishes the resources available for programs that provide support for the needy and for governmnent-aided capital investment.

Moreover, it is public investment—not private investment—that has been lagging during the past several years. In fact, in recent years, the business investment share of the economy has been at the highest level in the past 30 years. (See attachment No. 3.) Public investment, in contrast, has deteriorated. In a recent Commerce Department study of public sector capital formation, John C., Musgrave states:

"In contrast dollars total government net fixed capital formation has declined steadily since the mid-1960's from a high of $25 billion in 1966 to $7 billion in 1979. . . . Since the late 1960's the Federal component has been a small negative value, and the state and local component had declined by the late 1970's to about one-third of its value in the late 1960's.

In the headlong drive to enact massive tax cuts, while cutting government's social and economic development programs, the Administration is ignoring the crucial importance of the nation's public infrastructure to private sector growth, productivity, job creation and price stability. If, for example, the network of roads, rails and ports is allowed to continue to deteriorate, delays and difficulties in transporting goods will be reflectd in lost output and highr prices. Business expansion will be discouraged by inadequate sewer and water facilities, and by the inability of workers to get to work because public transit facilities are already operating at their capacity.

The Administration's individual tax cut proposal would also shift income within the private sector in favor of high income groups. While proponents argue that this redistribution is necessary to encourage private savings, the inequities implicit in such trickle-down notions far overshadow any possible benefits and conflicts with rationality. The well-to-do are also consumers. A March 9 Business Week article entitled, "Why Consumer Spending Hasn't Crumbled," provides an important perspective. The trust of the article is found in the following excerpt:

"The consumer market has been split into two tiers. In the top tier are high and upper-middle income families who, because of their rapidly expanding equity in

their homes and ability to reduce their taxable income by deducting interest costs and real estate taxes, have been able to continue to spend strongly. The health of the top tier has more than offset the weakness of the bottom tier, which has been battered by rising food, fuel and housing costs."

The article also points out that the richest 10 percent of all households account for 60 percent of all retail sales and two-thirds of all spending on highly-discretionary consumer goods.

The business depreciation proposal amounts to a rapid and arbitrary speedup in depreciation write-offs which would destroy the concept of business "taxable income." Huge revenue losses would result and the corporate contribution to the cost of government would be cut by more than one-third. By 1986, according to the Administration's budget projections, the corporate income tax will account for only 7.6 percent of budget receipts. In 1960, the comparable figure was 23 percent and currently it is 11 percent.

Because of the across-the-board nature of the proposal and the unfocused manner in which the benefits would be distributed, huge amounts of foregone revenue would end up subsidizing investment that would take place anyway and providing added cash to buy other companies, increase dividends, invest overseas, speculate, or to finance shut-downs and relocations that destroy jobs and blight local communities.

The only certainty is that corporate cash flow will increase and federal revenues will diminish. How much of the additional cash flow will go to productive, economy building investment will be determined behind the closed doors of corporate board rooms.

In a major study released by the Treasury on the effects of such tax policies on investment the authors, R. S. Chirinko and Robert Eisner of Northwestern University, noted that:

"We found little evidence that a dollar of lost tax revenues from 10-5-3 or the investment tax credit would ultimately gain more than 40¢ in added investment. It would be more cost-efficient to have the government buy the new plants and equipment and give them to business."

We should like to point out that this depreciation-speed-up proposal (as well as most others) is justified as a means to correct for inflation's impact on the value of depreciation write-offs. According to that argument annual depreciation deductions during periods of high inflation do not compensate for the cost of replacing the asset. But the Administration's proposal does not even meet the so-called "problem." The write-offs would be faster but any relationship to replacement cost or the rate of inflation would be purely accidental.

The measure would also continue to permit firms to "double dip." That is, companies can ignore the effect of the investment tax credit when calculating annual depreciation write-offs. Thus, a firm buying a piece of equipment which costs $100 receives a credit which cuts the actual cost of the equipment to only $90. Nevertheless, the corporation can still write off the full $100—in effect deducting 111 percent of its cost.

Mr. KIRKLAND. The proposal would substantially distort business investment decisions and change relative tax burdens. Larger, more prosperous capital-intensive firms would reap huge benefits while smaller, less prosperous labor-intensive firms would benefit very little. Healthy, growing corporations would receive tax bonanzas whether they need them or not and the competitive position of smaller firms would be further diminished.

We see no justification, particularly in this time of budget slashing and proclaimed need for austerity and sacrifice, to throw as much as $60 billion a year in Federal tax cuts to the Nation's corporations and their stockholders in the vain hope that this largess will trickle down to workers and consumers in the form of needed jobs and more goods and services at reasonable prices.

Mr. Chairman, we are convinced that curbing inflation, reducing unemployment, and solving fundamental problems requires a redirection of the Nation's resources. Additional private capital investment is needed in many, but not all industries and areas. Public capital formation cannot be ignored. Tax burdens are too high for many, but not all individuals, and the problems of the poor and the disadvantaged must be solved, not aggravated.

H.R. 3218 reflects those convictions—the administration's proposals do not.

INDIVIDUAL INCOME TAX REDUCTION PROPOSALS—ATTACHMENT NO. 1

	Administration proposal[1]—family of 4		H.R. 3218 proposal[2]
	1981	1st full yr	
Wage or salary income:			
$5,000			$66
$10,000	$26	$52	134
$15,000	75	150	200
$20,000	114	228	266
$25,000	153	306	333
$30,000	191	382	395
$40,000	324	648	395
$50,000	478	956	395
$100,000	920	1,840	395

[1] Assumes deductible expenses equal to 23 percent of income.
[2] A tax credit (refundable) equal to 20 percent of taxpayers 1981 social security payroll tax with equivalent reductions for public employees not covered by social security and those under railroad retirement.

DISTRIBUTION BY INCOME GROUP

	Reagan (in percent)	H.R. 3218 (in percent)
Income group:		
$0 to $15,000	10	20
$15 to $30,000	30	40
$30 to $50,000	31	30
$50,000 and over	29	10

EFFECT OF REAGAN 3-YEAR 30 PERCENT TAX CUT PROPOSAL ON INCOME—ATTACHMENT NO. 2

	Income after Federal taxes, current law[1]	Income after Federal tax under Reagan plan, 1984[1]	Percent increase in after-tax income
Wage or salary income:			
$10,000	$8,961	$9,065	1.2
$12,000	10,500	10,703	1.9
$20,000	16,657	17,225	3.4
$25,000	20,436	21,233	3.9
$30,000	24,088	25,138	4.4
$50,000	38,702	40,779	5.4
$100,000	70,147	76,579	9.2

[1] Includes social security taxes and is based on a 4 person family with deductible expenses equal to 23 percent of gross income.
Source: AFL-CIO Department of Economic Research.

INVESTMENT—ATTACHMENT NO. 3

	Nonresidential private fixed investment			Investment in nonresidential producers durable equipment	
	GNP	Billions of dollars	As a percent of GNP	Billions of dollars	As a percent of GNP
Year:					
1949	$258.3	$24.4	9.4	$15.7	6.1
1950	286.5	27.3	9.5	17.8	6.2
1951	330.8	31.3	9.5	19.9	6.0
1952	348.0	31.3	9.0	19.7	5.7
1953	366.8	34.5	9.4	21.5	5.9

INVESTMENT—ATTACHMENT NO. 3—Continued

	GNP	Nonresidential private fixed investment: Billions of dollars	Nonresidential private fixed investment: As a percent of GNP	Investment in nonresidential producers durable equipment: Billions of dollars	Investment in nonresidential producers durable equipment: As a percent of GNP
Year:					
1954	366.8	34.2	9.3	20.8	5.7
1955	400.0	38.5	9.6	23.9	6.0
1956	421.7	44.0	10.4	26.3	6.2
1957	444.0	47.0	10.6	28.6	6.4
1958	449.7	42.0	9.3	24.9	5.5
1959	487.9	45.9	9.4	28.3	5.8
1960	506.5	48.5	9.6	29.7	5.9
1961	524.6	48.0	9.1	28.9	5.5
1962	565.0	52.2	9.2	32.1	5.7
1963	596.7	54.8	9.2	34.4	5.8
1964	637.7	61.0	9.6	38.7	6.1
1965	691.1	72.7	10.5	45.8	6.6
1966	756.0	83.1	11.0	53.0	7.0
1967	799.6	83.9	10.5	53.7	6.7
1968	873.4	90.7	10.4	58.2	6.7
1969	944.0	101.3	10.7	64.6	6.8
1970	992.7	103.9	10.5	65.2	6.6
1971	1,077.6	107.9	10.0	67.4	6.3
1972	1,185.9	121.0	10.2	76.9	6.5
1973	1,326.4	143.3	10.8	92.3	7.0
1974	1,434.2	156.6	10.9	100.7	7.0
1975	1,549.2	157.7	10.2	102.3	6.6
1976	1,718.0	174.1	10.1	115.3	6.7
1977	1,918.0	205.5	10.7	140.9	7.3
1978	2,156.1	242.0	11.2	163.3	7.6
1979	2,413.9	279.7	11.6	183.4	7.6
1980	2,626.1	296.0	11.3	187.1	7.1
1981	2,826.8	314.7	11.1	198.5	7.0

Note.—1st quarter (preliminary).
Source: Department of Commerce, Bureau of Economic Analysis

The CHAIRMAN. Lane, thank you. Senator Long?

Senator LONG. Sometimes those of us sitting here lose sight of the fact that when we have witnesses in a room full of people, those people may represent only a very small percentage of America.

I read that 1,100 organizations—I don't think they include many labor organizations—but 1,100 primarily business groups rallied to support the bill that the President recommended without any amendment.

What percentage of the American people do you think those organizations amount to when you add them all up?

Mr. KIRKLAND. I really couldn't say.

Senator LONG. Well, sometimes in this room you get the impression that about 90 percent of Americans out there feel a certain way. But I guess it would really be more like about 6 percent at best; maybe 10 percent. Those organizations don't speak for many people in your union halls, do they?

Mr. KIRKLAND. I don't believe they do.

Senator LONG. Well, thank you for your statement.

Mr. KIRKLAND. Thank you.

Senator PACKWOOD [acting chairman]. Senator Mitchell?

Senator MITCHELL. Thank you, Mr. Kirkland, for your statement.

The administration witnesses have stressed that a major objective of the proposed tax program is to encourage savings. At the same time, the administration program would eliminate the only savings incentive, direct savings incentive that now exists. That is, the interest and dividend exclusion that permits a person to deduct interest earned up to $200 per person and $400 per joint return.

Do you feel that some specific savings incentive is an appropriate mechanism to encourage savings as opposed to just a general tax reduction that hopes that there will be savings?

Mr. KIRKLAND. Senator, if we were writing an ideal tax bill or presenting our views as to what a comprehensive tax proposal or fair and equitable bill to accomplish all of the objectives that we might seek in the way of general tax reform, we could, I think, include that in the comprehensive bill.

But, I believe that we have to look at this today in terms of lesser considerations—the use of alternatives or the reduction of revenues and how best to distribute them.

This is our considered judgment of the most that ought to be done at this particular time. There are a great many laudable objectives in tax legislation all of which cost revenue. We should prefer to see what we consider the maximum prudent available reduction in revenues allocated in this particular way.

Senator MITCHELL. In the bill to which you refer in your testimony?

Mr. KIRKLAND. Yes.

Senator MITCHELL. Thank you.

Senator PACKWOOD. I have no questions. Mr. Kirkland, thank you very much.

Next, we take John Rousselot.

STATEMENT OF HON. JOHN H. ROUSSELOT, U.S. REPRESENTATIVE FROM THE STATE OF CALIFORNIA

Mr. ROUSSELOT. I say to my colleagues from the Senate, thank you for the opportunity to appear before you today. I understand you are trying to keep the testimony moving so I will try to abide by that consideration.

I think that we can agree in Congress on the serious nature of our economic problems, especially the tremendous burden that taxation places upon all of our constituents.

Apparent agreement has been reached on the President's budget proposal which many of us feel is very vital toward restraining the explosion which has occurred in Federal spending.

Agreement must also be reached on the specifics of a tax reduction plan and I think, myself and many of my colleagues in the House and especially on the Ways and Means Committee, think that a tax reduction plan is essential to any program for economic recovery.

The need for tax reductions cannot be denied as the burden of taxes on individuals and businesses has become most oppressive.

For instance, in 1929, the average American worker earned enough to meet his tax obligations by February 9. In 1959, the same worker, and there are roughly 97 million in this country today, could not meet his total tax obligation until April 15. Today,

the average worker's entire salary from January 1 until May 11 is absorbed by taxes.

In 1965, only 6 percent of all taxpayers faced marginal tax rates of 25 percent or higher. Today, almost 40 percent of all taxpayers face rates of 25 percent or more.

Now, the previous administration estimated that tax receipts as a share of GNP would grow to the unprecedented level of 22.8 percent by 1984. According to the House Budget Committee report on page 31, "in 1981 Federal receipts are projected to exceed 21 percent for the first time since 1944," when of course we were in the middle of a war.

Oliver Wendell Holmes, Jr., once wrote, and you are all familiar with it because we have all used it in our political speeches: "The power to tax is the power to destroy." The economic policies of the past several years have most certainly shackled American initiative and destroyed incentives to work, save, and invest and those are very much a part of the fundamentals of productivity.

The Reagan tax plan relieves this tax burden first by keeping real taxes from increasing during the next few years; and second, by providing the necessary incentives to American workers and businesses to turn the economy around from a no-growth situation to one of high growth.

The President's proposal to reduce marginal tax rates by 30 percent over a 3-year period is an incentive tax policy which will reduce the tax disincentives for the labor and efforts of American workers and businesses. I clearly disagree with the previous witness that there is no incentive in the President's tax plan for the American worker.

I think there is a lot of incentive and I wish now to talk about that.

The key, as Treasury Secretary Donald T. Regan has stated before this committee last week, is to "give the economy back to the people."

The President has repeatedly stated that they are the ultimate source of the strength of this society.

I support the proposal for across-the-board reduction in personal marginal income tax rates without reservation, as I have done, by the way, for many years. This is certainly not new to me. I have been a cosponsor of many reductions in taxes for both individuals and businesses for better than 7 years.

I firmly believe that these reductions will provide equitable relief from the burden of high and rising taxes to all taxpayers, and at the same time create the kinds of jobs, expanding tax base, and economic growth that will mean a larger piece of a larger economic pie for everyone, as well as increased opportunities for all Americans.

Today, I would like to examine the Reagan tax proposal in terms of (1) the direct effects it will have on the economy, (2) its financial market effects, and (3) the equity of the proposal on taxpayers in all income tax brackets.

To examine the direct effects of the Reagan tax proposal and especially the across-the-board personal marginal income tax reductions on the economy, we have to look at their impact on both the demand side and the supply side of the economic equation.

I know that some of my colleagues will deny that there is a supply impact, while others will deny that there is any effect on the demand side.

I know of no way to settle on theoretical grounds alone whether either group is right. Those who deny a supply impact are asserting that people are relatively insensitive to monetary rewards in determining such things as how hard and long to work, what occupations to pursue and what risks to take.

Those who deny a demand impact are asserting either that interest rates are not affected by Government debt sales or, if they are, that the velocity of money is not sensitive to interest rates, or alternatively that saving and investment are extremely sensitive to interest rates. I do not want to get bogged down in these arguments. For my purposes, it is reasonable to rule out special cases and assume both a demand and a supply effect.

Well, Mr. Chairman, how tough are you sticking to your time?

Senator PACKWOOD. You will be up for about a minute and a half.

Mr. ROUSSELOT. Well, let me just say for purposes of illustration on the point I just made, I have attached two graphs found on page 19 of my testimony.

The first chart demonstrates the demand effect. Demand rises—a shift to right in the diagram—as a result of the tax cut. The increase in demand registers an increase in spending and, in response to the increased spending, prices tend to rise or be bid up and producers produce more.

Graphically, the move is, on the chart, from D1, the original demand curve, to D2 in response to the tax cut. You can see that the demand side impact, viewed alone is to increase both real GNP and prices.

The second diagram on page 19 helps us examine the supply side impact. We can see that the GNP will also increase as a result of the supply impact of a tax cut. By lowering marginal tax rates, more goods and services are provided.

Production increases because workers and producers now have increased incentives to work and produce. In graphic terms, these new incentives push the supply curve to the right, from S1 to S2.

In turn, the increase of goods and services provided in the economy causes prices to fall.

Let me just close by quoting President Kennedy, if I might. He recognized that a reduction in marginal tax rates would impact on supply in a speech in December 1962 before the Economic Club of New York when he stated:

> An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget, just as it will never produce enough jobs or enough profits. In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low—and the soundest way to raise revenues in the long run is to cut taxes now.

It is my belief that this statement of truth articulated by President Kennedy in 1962 is even more relevant today and I hope that this committee will help us produce, when we finally get a bill over here, a similar proposal.

Senator PACKWOOD. John, how is that, save Japan, all of our major international trading competitors have significantly higher

rates of taxation than we do and yet higher increases in productivity, higher rates of savings, and higher rates of capital investment?

Mr. ROUSSELOT. Well, of course, you have named part of it. They have much higher savings rates. I don't think they have the total burden of taxation that we do as it relates to social security taxes which——

Senator PACKWOOD. If we are talking about marginal rates.

Mr. ROUSSELOT. I understand. A combination of both Federal income tax and social security tax, I think is a terrible disincentive.

Senator PACKWOOD. Well, it turns out as a matter of fact, most of the European countries even have, in terms of equivalency, higher social security tax.

Mr. ROUSSELOT. You mentioned Japan.

Senator PACKWOOD. I said save Japan. Japan is unique. Japan provides through business what most governments provide through government and therefore, Japan, in terms of its relation of fringe to total payments, their fringe payments are about 67 percent of their total wage whereas ours on the average are about one-third.

It ends up in the cost of the product either way you do it, but Japan just chooses to do it through business. Forgetting Japan——

Mr. ROUSSELOT. So do our taxes, by the way, end up in products.

Senator PACKWOOD. Oh, yes, all taxes do. I keep coming back to why do they manage to save more, invest more, have higher rates in increasing productivity, and still tax their citizens substantially more in terms of the percentage of the gross national product.

Mr. ROUSSELOT. Well, I doubt the effective rate of their tax is quite as high as I read it.

Senator PACKWOOD. What do you mean their effective rate?

Mr. ROUSSELOT. The effective rate that each individual—are you talking about personal income tax now?

Senator PACKWOOD. I am talking about the total tax burden on the citizens in the different countries.

Mr. ROUSSELOT. Are you talking about West Germany, Japan, or who else? There is no doubt that in Sweden and some of those countries, the tax rates are overwhelming, and I wouldn't want to compare us to them.

Senator PACKWOOD. France, Italy, Denmark. This is the Office of Economic Cooperation and Development and it compared the tax rates in all of the countries that belong and these are all of the major industrial countries of the world. In the seven top ones, save Japan, they all tax their citizens more. Our tax rate, roughly, counting Federal, State, and local as a percentage of our GNP is about 32 percent.

Mr. ROUSSELOT. As a percentage of GNP.

Senator PACKWOOD. Yes, as a percentage of GNP. Germany, France, Italy all range any place from 39 to 42 percent.

Mr. ROUSSELOT. Not as a percentage of the individual wages.

Senator PACKWOOD. Well, I understand your answer, but I don't see the relevance of it.

Mr. ROUSSELOT. Well, I think it is very relevant if you relate to GNP as opposed to what it does to the individual. Of course, that is what many of us believe has been the basic problem here. That is with the combination of social security tax and personal income

tax we have provided many disincentives. I go into this point later on in my testimony, which I hope you will have chance to review.

We have so many disincentives to work, by the time you get to $25,000 or $30,000 or even less. There are great disincentives to work when one considers the combination of social security tax and personal income tax.

Senator PACKWOOD. Well, as I say——

Mr. ROUSSELOT. I have spent time comparing the United States to Japan and West Germany because I consider them real competitors in the marketplace. As I review both Japan and West Germany, they have far more incentives in their tax system as it relates to the individual than we do.

Senator PACKWOOD. Where they have their incentives is in dividends, interest, and capital gains.

Mr. ROUSSELOT. No doubt about it. That is one area.

Senator PACKWOOD. They actually, in terms of——

Mr. ROUSSELOT. And also in savings. They do not tax their savings as high as we do.

Senator PACKWOOD. It varies from country to country, but you are right.

Mr. ROUSSELOT. I think we cannot fail in our No. 1 bill to also address savings incentives and to make sure in the Ways and Means Committee we also address that issue. I don't want to limit——

Senator PACKWOOD. At incomes of $30,000 or less, what they have done is tilt their tax code very heavily toward the direction taxing much higher than we do of people in those income brackets.

Mr. ROUSSELOT. Yes, but they don't for savings and investment.

Senator PACKWOOD. Yes, but the problem is that the Roth-Kemp 10-10-10 does not very significantly shift that incidence of taxation. We will still have, counting social security taxes, one of the highest income and social security tax rates and also one of the very high taxes on interest, dividends, and capital gains. We don't tilt it in the direction they do.

Mr. ROUSSELOT. Well, you are talking to the wrong guy. I would just as soon totally eliminate—and you know I don't represent the majority here—capital gains tax entirely, but I know that is not politically possible and all the rest that goes with it.

I will say to you there is no doubt about the fact that we overtax the incentive to save and invest. There is no doubt about it. I hope that whatever tax package we finally produce includes some kind of an incentive to save. Of course, when we reduce the personal income tax rate, if we do in 3 years, the effect will be to reduce the individual capital gains tax roughly to 20 percent.

Senator PACKWOOD. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. Welcome to our committee over here, John. We are glad to have you over here and I am glad to have your very excellent statement.

In my opinion, we have the votes here in this committee and in the Senate to pass most of the President's tax bill despite what has been talked about a great deal lately in the newspaper.

Mr. ROUSSELOT. I heard the chairman of this fine committee on the Today Show yesterday tell us that he thinks we are moving toward agreement.

Senator SYMMS. What is happening over in the House side? When are you going to send us a bill?

Mr. ROUSSELOT. Well, our chairman Mr. Rostenkowski, tells us that we should move on a bill sometime within the next month and hopes to have it on the floor sometime in June.

I don't know how realistic that is, but that——

Senator SYMMS. Is it the kind of a bill that you would want to vote for?

Mr. ROUSSELOT. Well, assuming it has a multiyear reduction in personal income tax rates across-the-board. I personally, I would make it 5 years.

Senator SYMMS. I would make it six.

Mr. ROUSSELOT. And second, assuming that we have good accelerated depreciation reduction and third, assuming we have some kind of an incentive to save and I think we will probably include that too, then I think I would be very supportive.

Senator SYMMS. Good.

Mr. ROUSSELOT. As you gentlemen know, I have had tax reduction bills of the nature of all of these in for better than 7 years. I feel that we have been very slow in getting these tax reduction bills.

Senator SYMMS. Well, I certainly would agree with you, but don't you think that those that are critical of the marginal rate reductions and where that money will be spent, oftentimes look at just the amount of money that the person is going to not have to pay because of reduced marginal rates, but that the families look at their overall income and that there will be more savings whether there is a savings incentive in the bill or not even if you have a tax reduction.

Mr. ROUSSELOT. No doubt about it. I think the point that you are making, even though the "dollar amount" at the lower levels of family income doesn't look as great, it is still very significant to those individuals.

I remember when proposition 13 passed in California and reduced our property tax. The argument was made: only the big property owners would really benefit. But the dollar amount, though smaller to that individual, say that the property tax was $1,000 a year or $700 and even though that was a reduction of only $300 or $400, was still monumental for those individuals because their earning capacity was lower.

It is every bit as meaningful to the people earning $12,000, $15,000 a year as it is to the person earning, say, about a figure of $60,000.

Senator SYMMS. Right. Thank you.

Mr. Chairman, in your absence we passed the tax bill before the August recess.

The CHAIRMAN. Good, well I appreciate that. I hope that you got social security on it too.

Senator SYMMS. Glad to know that. John, I would like to ask you one other question.

Mr. ROUSSELOT. By the way, before I proceed, Mr. Chairman, I ask unanimous consent, since I tried to abide by your time limitations, to submit my entire statement at this point.

The CHAIRMAN. I will be glad to put it in. We will even have it reprinted.

PREPARED STATEMENT OF JOHN H. ROUSSELOT, U.S. REPRESENTATIVE

We can agree in Congress on the serious nature of our economic problems. Apparent agreement has been reached on the President's budget proposal, vital toward restraining the explosion which has occurred in Federal spending. Agreement must also be reached on the specifics of a tax reduction plan, essential to any program for economic recovery.

The need for tax reductions cannot be denied as the burden of taxes on individuals and businesses has become oppressive.

In 1929, the average American worker earned enough to meet his tax obligations by February 9. In 1959, the same worker could not meet his total tax obligations until April 15. Today, the average worker's entire salary from January 1 until May 11 is absorbed by taxes.

In 1965, only 6 percent of all taxpayers faced marginal tax rates of 25 percent or higher. Today, almost 40 percent of all taxpayers face rates of 25 percent or more.

The previous administration estimated that tax receipts as a share of GNP would grow to the unprecedented level of 22.8 percent by 1984. According to the House Budget Committee report, page 31, "In 1981 Federal receipts are projected to exceed 21 percent for the first time since 1944."

Oliver Wendell Holmes, Jr., once wrote: "The power to tax is the power to destroy." The economic policies of the past several years have most certainly shackled American initiative and destroyed incentives to work, save, and invest—the fundamentals of productivity.

The Reagan tax plan relieves this tax burden first by keeping real taxes from increasing during the next few years; and second by providing the necessary incentives to American workers and businesses to turn the economy around from a no-growth situation to one of high growth.

The President's proposal to reduce marginal tax rates by 30 percent is an incentive tax policy which will reduce the tax disincentives for the labor and efforts of American workers and businesses.

The key, as Treasury Secretary Donald T. Regan stated before this committee last week, is to "give the economy back to the people." The President has repeatedly stated that they are the ultimate source of strength of this society.

I support the proposal for across-the-board reductions in personal marginal income tax rates without reservation. I firmly believe that these reductions will provide equitable relief from the burden of high and rising taxes to all taxpayers, and at the same time create the kinds of jobs, expanding tax base and economic growth that will mean a larger piece of a larger economic pie for everyone, as well as increased opportunities for all Americans.

Today, I would like to examine the Reagan tax policy in terms of: (1) The direct effects it will have on the economy, (2) its financial market effects, and (3) the equity of the proposal on taxpayers in all income tax brackets.

DIRECT EFFECTS

To examine the direct effects of the Reagan tax proposals and especially the across-the-board personal marginal income tax reductions on the economy, we have to look at their impact on both the demand-side and the supply-side of the economic equation.

I know that some of my colleagues will deny that there is a supply impact, while others will deny that there is a demand impact. I know of no way to settle on theoretical grounds alone whether either group is right. Those who deny a supply impact are asserting that people are relatively insensitive to monetary rewards in determining such things as how hard and long to work, what occupations to pursue, and what risks to take. Those who deny a demand impact are asserting either that interest rates are not affected by Government debt sales or, if they are, that the velocity of money is not sensitive to interest rates, or alternatively that saving and investment are extremely sensitive to interest rates. I do not want to get bogged down in these arguments. For my purposes, it is reasonable to rule out special cases and assume both a demand and a supply effect.

For purposes of illustration, I refer to the two graphs found on page 19 of my testimony. The first chart demonstrates the demand effect. Demand rises (a shift to the right in the diagram). As a result of the tax cut, the increase in demand registers an increase in spending. And, in response to the increased spending, prices tend to rise (be bid up) and producers produce more. Graphically, the move is from

D1, the original demand curve, to D2, in response to the tax cut. You can see that the demand-side impact, viewed alone, is to increase both real GNP and prices.

The second diagram on page 19 helps us examine the supply impact. We can see that GNP will also increase as a result of the supply impact of the tax cut. By lowering marginal tax rates, more goods and services are provided. Production increases because workers and producers now have increased incentives to work and produce. In graphic terms, these new incentives push the supply curve to the right, from S1 to S2. In turn, the increase of goods and services provided in the economy causes prices to fall.

President Kennedy recognized that a reduction in marginal tax rates would impact on supply in a speech in December of 1962 before the Economic Club of New York when he stated:

"An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget—Just as it will never produce enough jobs or enough profits. In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low—and the soundest way to raise revenues in the long run is to cut rates now."

President Kennedy elaborated upon this point in his 1963 economic report: "Only when we have removed the heavy drag our fiscal system now exerts on personal and business purchasing power *and on* the financial *incentives for greater risk taking and personal effort* can we expect to restore the high levels of employment and high rate of growth that we took for granted in the first decade after the war." (My emphasis.)

These remarks by President Kennedy are even more applicable today as the drag on our economy is greater now than it was almost 20 years ago.

The diagrams on page 19 demonstrate that if President Reagan's tax cuts are enacted into law, real GNP will increase. This result is unambiguous. It is a logical deduction from both demand and supply side economics. More goods and services will be provided to the economy as a result of the reduction in marginal tax rates.

There is some uncertainty, however, about prices and inflation. The demand impact tends to cause prices to rise, while the supply impact produces a decrease in prices and inflation. The question is which of these two impacts will dominate? In my opinion, it is reasonable to assume that the two impacts will offset each other and no increase or decrease in inflation will occur as a result of the tax reduction. In this regard, I want to stress that those of us who favor the tax cut, and argue that it won't be inflationary, do not have to prove that there is no demand effect, or even that its inflationary impact is less important than the supply-side inflation impact; however, but those who argue that the Reagan tax cuts will be inflationary must demonstrate either that there is no supply effect or that its inflation impact is relatively small. I would be happy to examine evidence which would indicate that either of these contentions about the supply impact are true.

In my opinion, inflation is primarily a monetary phenomenon. This is what data for the past 25 years assembled in the Joint Economic Committee's 1981 Joint Economic Report show. From 1955 to 1964, GNP inflation (the rate of rise of the GNP deflator) averaged 1.99 percent a year while the growth of M1-B, the conventional measure of money (currency plus transactions or checking deposits in depository institutions), averaged 1.94 percent per year. In the next 10 years, money growth averaged 5.55 percent a year and inflation 4.80 percent. From 1976 to 1980, money grew 6.62 percent a year and yearly inflation averaged 7.52 percent. In the last 4 years, 1977 to 1980, yearly money growth averaged 7.40 percent and inflation 7.66 percent. Thus, it would appear that if there is a demand impact from fiscal policy which is independent of money growth, it is either trivial or offset by the supply impact.

To summarize, the direct impact of across-the-board personal marginal tax rate cuts will be to increase GNP, or real growth, with no increase in prices.

FINANCIAL MARKETS

The second question I would like to address today deals with the impact of the Reagan tax policy on financial markets.

There have been claims made that unless Government spending is restrained by the exact same amount, dollar for dollar, as the tax reductions, disastrous consequences will befall financial markets. While this claim can be made for some types of tax cuts, such as a tax rebate, this scenario, I think, is completely false in reference to business tax cuts and across-the-board cuts in personal marginal income tax rates.

Because the Reagan tax proposal addresses the need for new incentives to produce new income, reflows will occur through an expanded tax base—due to the real growth in the economy which is induced by the lowering of marginal tax rates. In

addition, savings flows will increase. Allow me to use some figures also assembled in the Joint Economic Committee's 1981 report with reference to fiscal years 1981-82 to illustrate this point.

The Reagan proposal would reduce personal taxes by $44.2 billion (through lower marginal tax rates) and business taxes by $9.7 billion (through accelerated cost recovery) in fiscal years 1981 and 1982. (The total reduction is $53.9 billion.) Using a conservative estimate, during the next few years the tax cuts for fiscal years 1981-82 would increase real GNP by $90 billion. This increased economic base would feed back, even under the most conservative estimate, $30 billion in added tax revenues to Federal, State and local governments. (One-third is the approximate proportion that government takes of GNP.) In addition, personal and business savings would rise by $6 billion, and another $10 billion in business savings results automatically from the accelerated depreciation allowances. By summing these figures ($30, $6, and $10 billion) we find that only $8 billion of the $53.9 billion total tax reduction would still need to be financed. However, there will be no problem financing this amount. New sources of funds will emerge due to the change in relative prices, which the Reagan income tax cuts will produce.

It is important to understand that a cut in marginal tax rates does not just affect those dollars returned to the taxpayers. It affects how they earn more dollars. The reduced marginal rates change their behavior in all areas where they were previously taxed more. So we cannot just view a reduction in the marginal rates as only a $54 billion tax reduction. It is an incentive tax cut and a change in the entire system, removing previous disincentives to work, save, and invest.

One of the major purposes of the Reagan tax proposal is to alter incentives by changing the two relative prices: Of work and leisure (the two uses of time) and current consumption and future consumption (the two uses of income). Every taxpayer faces these relative costs or prices. As you know, income taxes raise the cost of working as compared to not working. The higher the marginal tax rate, the higher is the cost of working since less after-tax income is being earned. The higher the tax rate the more attractive leisure, which is not taxable, becomes as the alternative use of time. In the same manner, the cost of saving relative to consumption, and the cost of earning taxable income relative to earning untaxed income are also both increased by taxes. Thus, by reducing marginal tax rates, people will have new incentive to work, produce, and spend less.

It is important to realize that the aggregate effect of small individual responses to the improved incentives for work, saving, and investment will lead to enormous increases in our Nation's productivity and saving. Dr. Paul Craig Roberts, Assistant Treasury Secretary for Economic Policy, wrote in the March 19, 1981 Wall Street Journal:

"For the supply-side to work, taxpayers don't have to respond to lower marginal tax rates by giving up vacations, going on a double shift and saving all of their income. When you have a work force of more than 100 million people, small individual responses result in a large aggregate effect. If the average number of hours worked per week rises from 35 to 35.5, GNP rises by $24 billion. If the absentee rate declines by one-half percentage point, GNP rise by about $10 billion. If the personal savings rate rises from about 5.5 percent to about 7.5 percent, as it did after the Kennedy tax rate reductions, private savings increase by $42 billion annually at current income levels."

Those who claim reducing marginal tax rates will not increase incentives to work, save, and invest, preach a counsel of despair. This is in effect saying that people do not respond positively to increased after-tax income or higher rates of return on savings and investment. The work ethic is not dead; it only needs to be unharnessed. History shows this to be the case.

Increased work incentives will increase real GNP as the employee's after-tax return from an extra hour of work is increased. Labor force participation rates will increase or, what amounts to the same thing, fall more slowly. In the 3 years before the Kennedy tax cuts, the labor force participation rate of males declined 1.9 percentage points and the rate of females rose .6 percent. In the following 3 years, the male rate declined only 1 percentage point and the female rate rose 2 percentage points.

Economists have long agreed that females are sensitive to changes in the return to work relative to leisure. Recent evidence presented to a Brookings Institute conference by Professor Jerry Hausman, of MIT, shows that males also respond significantly and positively to changes in the return to work including those brought about by changes in tax rates.

Second, the average duration of unemployment will fall. After the Kennedy tax cuts it fell from 14 weeks in 1963 to 13.3 in 1964, 11.8 in 1965, and 10.4 in 1966. In

addition, unemployment after the Kennedy tax cuts declined and stayed below 5 percent for the rest of the decade.

Third, hours worked per week by full-time workers will rise. Again, after the Kennedy tax cuts, in manufacturing average weekly hours rose from 40.5 in 1963 to 40.7 in 1964, 41.2 in 1965 and 41.4 in 1966. In construction, it rose from 37.3 in 1963 to 37.6 in 1966. In wholesale and retail trade, it fell, reflecting the employment of part-time workers in this sector.

Finally, young adults will have increased incentive to upgrade their skills and enhance their human capital. This is because with the Reagan tax cuts they will be able to keep more of their incremental future earnings than they can look forward to under present law. Over the long run, this should add greatly to productivity and growth.

With the tax cut it also will be more profitable to save rather than consume. Hence saving will increase. Presently savings is discouraged because the taxpayer receives a higher return from buying goods or low-yielding investments than from saving or investing through productive financial assets. (Double inhibition on savings.)

As a result of the Kennedy tax cuts, the last time personal marginal tax rates were reduced, personal savings and corporate undistributed profits rose from 7.1 percent of GNP in 1963 to 8.4 percent in 1964, 9.2 percent in 1965, and 9.0 percent in 1966. Based on this experience, we can expect incremental savings of $38 billion the year the Reagan tax cuts are fully in place and $56 billion 2 years later. This too will greatly help in our battle to increase capital formation, productivity, and growth.

Research by Stanford Professor Paul Evans, published by the Federal Reserve Bank of San Francisco only recently, May 8, 1981, concludes: "Despite all the changes in the economy since 1964, the best available evidence supports the administration's position that Kemp-Roth would raise saving. The critics who assert that there is not a shred of evidence to support this claim just have not looked for it."

It must also be understood that a reduction in marginal tax rates is not just an individual tax cut, it is also a business tax cut. This is becaue the Reagan proposal will also drop the capital gains tax rate from 28 to 20 percent. Further, the tax rate on investment income will drop by increasing the rate of return on all forms of taxable investment income, and the proposal will increase returns to unincorporated businesses and partnerships.

In regard, once again, to the financial markets, there is one word of caution which must be advised. We must be careful not to talk ourselves into delaying or scaling down the tax reduction on the basis of a misinterpretation of the bond markets and interest rates.

As you know, there is a certain inclination by some to indicate that the bond markets have reacted out of fear of anticipated deficits or to the Reagan program. The reaction by the markets and the increased interest rates has been a response to the fact that the Federal Reserve has failed to control the growth of the monetary aggregates as they should.

Alan Reynolds, vice president of the First National Bank of Chicago recognized this when he recently stated, "The renewed collapse of stocks and bonds clearly reflects doubts about the objective methods and consistency of Federal Reserve policy, aggravated by a recent explosion in the growth of the money supply."

For the 3 months ending in April, M1-B, which measures the Nation's means of payment, grew at an annual rate of 13 percent. This is four times as fast as our economy's long-run, real growth potential. Investors naturally are fearful of holding bonds and other securities in this inflationary environment. It is not surprising that interest rates have soared. Inflation will not be controlled and interest rates won't be reduced, until a stable, noninflationary monetary policy is put in place.

If we talk ourselves out of going ahead rapidly and restoring the incentives our American taxpayers so desperately need, we will only guarantee that deficits will continue. We will remain in the deficit mode. If we instead adopt the Reagan program for economic recovery, the budget and economy will be balanced on strength and prosperity. This is the only way to correctly deal with our present economic situation and to attain a higher economic growth path. To the extent tht we scale down the administration's tax plan, we will only achieve a part of the results as the incentives that individuals and businesses may respond to will also be scaled down.

In summary, by enacting the President's across-the-board reductions in personal marginal income tax rates there will be a more efficient use of time, capital, and labor, resulting in more work, saving, risk taking, and entrepreneurship, as well as reductions in the underground economy, tax-sheltered investments, tax deductible

consumer borrowing, and static investments in gold, silver, art objects, and similar pursuits. It will become more profitable to earn an additional dollar rather than to conceal a dollar or invest it it low-yielding uses of funds. As George Gilder has accurately pointed out, "With taxshelters, high marginal tax rates redistribute taxpayers, not income."

Each of these latter activities will occur less and less as marginal tax rates are brought down. These previously less or untaxed uses of labor and capital will now contribute further to Government revenues, and expanded tax base, and increased saving. Together they will easily cover the final $8 billion borrowing requirement from the tax cuts of fiscal years 1981 and 1982.

There is even a change that the marginal tax rate reductions will increase Government revenues by more than the static amount taxes will be decreased. However, I want to stress that this result is not necessary to avoid a collision in financial markets because of the increased savings—personal and business—that will be generated to help finance any deficit that may emerge. Nonetheless, past experience demonstrates that tax-rate reductions can pay for themselves. The Kennedy tax cuts of 1964-65 generated $143 billion more in revenue than the Treasury predicted. Similarly, the capital gains tax reduction of 1978 resulted in $3.8 billion more receipts than estimated by the Treasury Department. Many also will recall the high reflows experienced in the 1920's when Treasury Secretary Andrew Mellow cut the highest marginal tax rate from 73 percent in 1921 to 25 percent in 1925.

EQUITY

My third point addresses the equity of the tax proposal for all taxpayers.

Recently, the basic fairness of across-the-board cuts in personal marginal income tax rates has been misrepresented. It has been asserted that the Reagan proposal cuts the taxes of the rich too generously and the taxes of the poor and middle classes too little. These claims are based on comparisons of the nominal dollar amounts returned to upper and lower income brackets. On the contrary, nothing could be more fair than the Reagan proposal. A comparison of the tax savings that will accrue to low and high income taxpayers under the Reagan plan demonstrates this.

Under present law, a four person family earning a $10,000 wage income will have to pay $1,496 in taxes during the next 4 years. Under the administration's proposal, the same family will pay (in the same period $1,226, thereby saving $270 or 18 percent of its taxes. The same sized family earning $20,000 in wage income will also save 18 percent of its taxes over the 4 years (paying $8,052 under present law and $6,596 under the Reagan proposal). A family of four earning $40,000 will save roughly 17.5 percent in taxes (paying $25,248 under present law and $20,836 under the President's proposal). With a wage income of $100,000, only 14.3 percent will be saved (present law $111,512, proposed $95,547) and in the $200,000 income bracket a relatively much smaller 8.8 percent will be saved in taxes (present law $265,512, proposed $241,999). These figures are tabulated in my testimony on page 20.

Clearly it cannot be claimed that the Reagan marginal tax reduction proposal is biased toward helping those in the upper income brackets. Any bias that occurs is tilted toward those in the lower income classes. As the Reagan proposal, "A program for economic recovery," points out, "The Distribution of the reduction is spread in proportion to taxes paid in all income classes." If an individual is paying $100 in taxes under present law, he will save $27 and pay $73 in the fourth year when the tax cut is fully in place. Similarly, persons paying $10,000 in taxes under present law will save $2,700. What could be more fair than a scaled-to-taxes paid reduction, which uniformly reduces tax rates providing a balanced benefit for all income levels. Clearly, the Reagan tax proposal is as fair as fair can be to those in the lower and middle-income brackets.

Continuing this argument, it is important to realize the effect that bracket creep has had on middle and upper income individuals since 1967. The chart, found on page 21 of my testimony is taken from the 1981 Joint Economic Committee Report. This chart demonstrates that the tax burden on our working people has become oppressive not through legislation but through inflation.

"For example, a married person, filing a joint return, with $16,001 taxable income in 1967 and the same real, inflation-adjusted income in 1980 ($35,920), was taxed at the margin by the Federal Government at 28 percent in 1967, and 43 percent in 1980" (1981 joint ecomomic committee report, page 86).

Also of interest is that the break even point for a married person filing a joint return, that is that income level where taxes do not have to be paid, taking into account earned income tax credits, has risen to $8,649. These figures show that we have been protecting low-income taxpayers from inflation's tax effects while allowing bracket creep to reduce after-tax returns to middle and upper income taxpayers.

It is obvious that incentives to work, save, and invest have thereby been drastically reduced from the levels of 1967. This inequity must be corrected. The across-the-board marginal tax cuts proposed by the President will correct it.

As President Reagan told the Nation in his address before a joint session of Congress on April 28, 1981: "The discussion has to do with how much of a tax increase should be imposed on the taxpayer in 1982. A gigantic tax increase has been built into the system. We are proposing nothing more than a reduction of that increase."

It is true that future inflation will distort the Reagan tax structure just as past inflation distorted the Kennedy structure. Tax rates will increase most for middle income persons and families as a result of bracket creep. This is because our tax structure is progressive with an upper limit. Those already in the highest tax bracket cannot be pulled into a higher bracket. This means that unless we stop inflation, and to the extent that we don't we're going to have to cut tax rates across-the-board again in a few years. But of course we can stop inflation, and we will, if we put the Reagan program in its entirety into place: Tax reductions, spending reductions, regulatory reform, and stable monetary growth.

By choosing this course, as President Reagan has pointed put: "We will restore the freedom of all men and women to excel and to create. We will unleash the energy and genius of the American people—traits which have never failed us."

We will accomplish this by giving the economy back to the American people.

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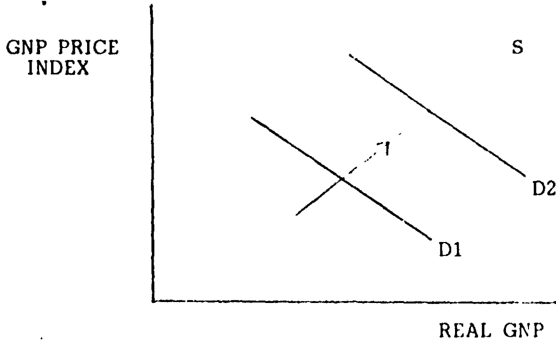
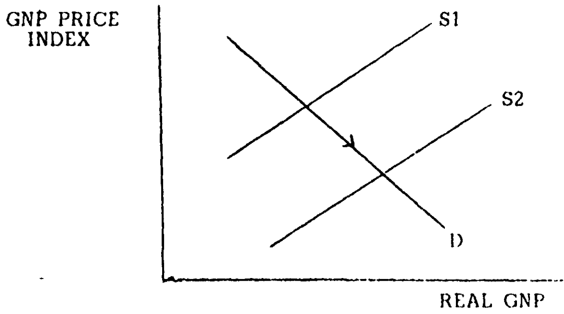
ACROSS-THE-BOARD PERSONAL MARGINAL
INCOME TAX REDUCTION PLAN

DEMAND EFFECT



SUPPLY EFFECT



4-PERSON FAMILY TAX LIABILITY

	4-year tax totals		Administration's proposal, 4-year saving	
	Present law	Administration	Dollars	Percent
Wage income:				
$5,000	$-2,000	$-2,000	0	0
$10,000	1,496	1,226	270	18.05
$15,000	4,932	4,034	898	18.21
$20,000	8,052	6,596	1,456	18.08
$25,000	11,604	9,570	2,034	17.53
$30,000	15,668	12,988	2,680	17.10
$40,000	25,248	20,836	4,412	17.47
$50,000	37,292	30,748	6,544	17.55
100,000	111,512	95,547	15,965	14.32
$200,000	265,512	241,999	23,513	8.86

Source: Calculated from "America's New Beginning: A Program for Economic Recovery," pt. IV. pp. 19, 21, 23, and 25.

TAX RATES ON SAME REAL TAXABLE INCOME [1] (1967 AND 1980)

	1980 equivalent inflation-adjusted taxable income	Marginal percent tax rates		Average percent tax rates	
		1967	1980	1967	1980
1967 taxable income:					
$1,000	$2,245	15	0	14.0	0
$4,000	8,980	19	18	15.5	9.8
$8,000	17,960	22	24	17.3	15.3
$12,000	26,940	25	32	18.8	19.5
$16,000	35,920	28	43	20.4	23.6
$20,000	44,900	32	43	21.9	27.5
$24,000	53,880	36	49	23.2	31.0
$28,000	62,860	39	54	25.4	33.8
$32,000	71,840	42	54	27.1	36.3
$36,000	80,820	45	54	28.7	38.3
$40,000	89,800	48	59	30.4	40.1
$44,000	98,780	50	59	32.0	41.8

[1] For married persons filing joint return.

Source: The 1981 Joint Economic Report, Report of the Joint Economic Committee on the 1981 Economic Report of the President, House Report No. 97-5, p. 103.

Senator SYMMS. John, what I want to ask you now is let's say, for example now, you and I are both very optimistic that we are going to pass most of Reagan's tax package. There are some spending restraints put into effect now, probably not enough. We should be balancing the fiscal year 1982 budget starting the first of October out of current revenues. That is not being done, but nevertheless spending is starting to come into effect and slowdown.

Mr. ROUSSELOT. Well, on the basis of some of the voices of fear and doom that I hear on my——

Senator SYMMS. There are some regulatory reforms on the horizon that look like they will be helpful to encourage productivity.

But, the fourth point of the Reagan economic package is monetary restraint at the Federal Reserve Board. What recommendations would you have? I know you spent many years on the House Banking Committee, now you are on the House Ways and Means Committee. What are you recommending from your point of view? What can be done about the fact that the Fed is continually expanding the money supply, thereby keeping the pressure up for interest rates?

Mr. ROUSSELOT. That is a very key area. I think that you don't just escalate interest rates alone as a method of slowing down money supply.

I hope that the President was able to convince the Chairman of the Federal Reserve Board when he met with him the other day that equally important is what the Federal Reserve does to help use those instruments available to it to slow down the accelerated increases in money supply.

Our normal measure is M1B and the hope is that the accelerated increases that occurred the last 6 months of last year and part of this year in money supply itself, be slowed. I hope the President was able to put that point over when he met with the Chairman of the Federal Reserve Board the other day.

Senator SYMMS. Mr. Chairman, could I ask one more question that relates to this, please?

Dr. Meiselman from Virginia Polytechnical Institute testified before this committee Monday morning. I asked the question what would you do as a Member of Congress or a Senator if you were there now, about this outrage that the Fed continues to talk that they are reducing the supply of money and every Friday the report comes out that they have increased it.

He said that the Congress has the authority to set guidelines for the Federal Reserve Board of how much they can expand the money supply and then set those guidelines and make the Fed stay within that parameter.

We had another witness that made the same comment on—I guess it was last week that Dr. Meiselman testified—it was Monday morning that another witness made the same observation that since we do not have the Fed tied to a gold standard as it should be, but we are not quite able to get that accomplished yet either.

Mr. ROUSSELOT. On page 13 of my testimony, I comment on this point and quote Alan Reynolds, vice president of the First National Bank of Chicago as follows:

> The renewed collapse of stocks and bonds clearly reflects doubts about the objective methods and consistency of Federal Reserve policy, aggravated by a recent explosion in the growth of money supply.

The gentleman is absolutely correct. It is an equally important part of the Reagan economic package to begin to put restraints on the growth of money supply. Now, as the gentleman knows, this Congress a long time ago delegated away an awful lot of authority——

Senator SYMMS. The point that Dr. Meiselman made, though, was that the Congress has control over the Fed and we are not exercising our ability and that the President doesn't have it.

Mr. ROUSSELOT. Well, we never really have, and part of the reason is that unfortunately, Congress has really always, in recent years, been a major advocate of expanding money supply more rapidly.

Now, you and I on this side of Congress have greater restraints now exercised by the voices that are in control, but you are right.

Senator SYMMS. You think we should, then, set targets for the Fed and make them live within it or——

Mr. ROUSSELOT. Well, as you know the Federal Reserve Board Chairman comes up to testify twice a year before the two banking committees on each side and I think that is the time that Congress should express itself very clearly on the restraints on money supply.

Senator SYMMS. I know I have gone past my time and I thank you, Mr. Chairman. Mr. Chairman, maybe what we should do is have the Chairman of the Fed come up and testify to our committee since we are the ones who get to vote to cut social security benefits because it will all go for naught if the Fed doesn't cooperate on this.

Mr. ROUSSELOT. Good point.

The CHAIRMAN. We are exploring that possibility.

Senator Bradley has some questions, but first I want to just—are you on the Social Security Subcommittee?

Mr. ROUSSELOT. I am. We have been working on it for 4 weeks and as a matter of fact one of the reasons that President Reagan responded with his suggestions through Secretary Schweiker was because the Social Security Subcommittee and my distinguished Chairman Mr. Pickle pushed the heck out of him to come up with some ideas.

We may not like all those ideas. I happen to have thought that most of them, of the 13 proposals made, were very reasonable.

The CHAIRMAN. Let me ask a question if you are finished. As I recall, one of the provisions in the Pickle bill would reduce benefits for early retirees to a level of 64 percent, phasing that reduction in starting in 1990. Is that correct?

Mr. ROUSSELOT. That is correct. That is what we have already voted on in the subcommittee.

The CHAIRMAN. I have heard so much discussion by—I guess the Democrats voted unanimously yesterday to go against the President and I found it to be rather strange since they have been in control for 26 years and now we have to fix up the system, I would hope that we will have bipartisan support in making some of these tough decisions.

They are not easy. I want to commend you and Mr. Pickle for the work you are doing on the House side in a responsible way. You may be back later on that issue.

Mr. ROUSSELOT. I am sure we will be. As you know, when the social security system was started all this early retirement wasn't in place and the retirement age was considered 65. We have escalated the benefits far beyond the ability to pay for them and one of those areas is early retirement between 62 and 65. We have to do something.

The CHAIRMAN. You may not have to do it.

Mr. ROUSSELOT. We may not do exactly what the President recommends.

The CHAIRMAN. There are a lot of things you can do. I understand the administration is very willing to compromise and certainly there are a lot of compromises around Congress.

Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman. I would like to compliment Congressman Rousselot on his leadership in the House in the effort to reduce marginal tax rates and unleash the produc-

tive capacity of this country. I agree that if we reduce marginal tax rates then in time, it will result in much greater savings and much more investment. I think that you really have taken the leadership on the Ways and Means Committee to accomplish that objective.

I think you more or less laid out in your testimony a comprehensive economic program for growth in this country. Sometimes when you are out in front on issues you sometimes are misunderstood.

My question to you is why do you think or how do you see the program faring in the House and do you think that your colleagues will see that a rising tide does lift all boats?

Mr. ROUSSELOT. I hope so. Right now, I will tell the gentlemen there is very little controversy over the Reagan package relating to accelerated depreciation.

There is very little controversy that we need some kind of an incentive to save. The main controversy, as you are well aware, is we don't quite have six Democrat votes on the Ways and Means Committee side to achieve the multiyear or 3-year reduction. Although Congressman Hance of Texas, who is a member of the Ways and Means Committee, has suggested a proposal of a 25-percent reduction in marginal tax rates across-the-board over a 3-year period, which is 5-percent less than the President's tax reduction plan.

Congressman Hance claims that he is very close to getting six votes for that concept in the Ways and Means Committee. But, I can tell the good Senator from New Jersey that we are close to achieving a multiyear marginal tax reduction in personal income tax rates, but what the final refined package will be, I can't tell.

That is the one area where, you are well aware, there has been the most controversy.

Senator BRADLEY. Are you of the view that with the President's enormous popularity and the rightness of your position on this issue, that if both marginal tax rates and the budget are reduced significantly, it will not put the economy back on a growth path unless you also have strict monetary policy? Do you think that reduction of marginal tax rates in the budget is sufficient?

Mr. ROUSSELOT. I think the monetary policy, as President Reagan stated in his initial statement to the Congress, is important and I think that is why he made it the fourth plank of his economic recovery package.

I am sure that is why he had the discussion the other day with the Chairman of the Federal Reserve Board.

I am not prepared to say that you can totally disregard the monetary policy. I think that would be totally unwise. I think it is an important part of the whole effort. But, I think we as a Congress cannot just sit by and do nothing on the things on which we can act, which is tax policy and budget policy. I would say to my colleague from New Jersey that I think it is important to move ahead with the parts of the economic package which we can have something to do with. Maybe Senator Symms is correct in saying that this committee should have the Chairman of the Federal Reserve Board up to talk about what he can do on the monetary side.

Senator BRADLEY. But, my point is, as someone who has been in the trenches out there fighting for the reduction of marginal tax

rates, courageously for a number of years, why do you think people don't see your point of view? Why do you think there is even any resistance among the Republican party with the President who has committed himself so firmly to this and with such sizable majorities in the Senate and with clearly a victory attained in the House? Why do you think there is anyone who would dispute the correctness of the argument or resist the popular President?

Mr. ROUSSELOT. Well, I think you are seeing a change in attitude as a result of the President being, frankly, such a good spokesman. I think you will probably see him take to the airwaves again.

Senator BRADLEY. Do you think that you will see him take to the airwaves on marginal tax reductions before the vote in the House?

Mr. ROUSSELOT. Well, maybe. I don't run his schedule but I have encouraged him to do it. Others have, too. I am not the only one.

Senator BRADLEY. Why do you think there is any resistance in the Republican party?

Mr. ROUSSELOT. Because this is a change of direction. Congress for years, which as you know has been run by your party, has been going in the other direction by keeping taxes high. We have had automatic increases as inflation kicks people into higher and higher tax brackets. People really genuinely believe that unrestrained spending by the Federal Government creates inflation also.

It has become excessive in both areas. Both tax policy, and in Federal spending. I know I don't have to convince you——

Senator BRADLEY. I think you are making the argument for why your party should be supporting the President's program 100 percent.

Mr. ROUSSELOT. I can tell you in the House, we are very united on the Ways and Means Committee. Out of 190 Members of the House, an overwhelming majority, probably very close to 175 are very supportive of the reduction in marginal tax rates over a period of 3 years.

Senator BRADLEY. In this committee in these hearings, I have heard as many objections on the Republican side as on the Democratic side. I am curious as someone who has been out there, why do think that is so?

Mr. ROUSSELOT. Remember the President's tax package has several parts and I have not heard any Republicans say we don't need accelerated tax reduction. Have you?

Senator BRADLEY. I have heard many Republicans say they have great skeptcism about a 3-year marginal tax cut.

Mr. ROUSSELOT. I don't remember any Republican on this side saying they are against new accelerated depreciation schedules. Mr. Chairman?

The CHAIRMAN. I will double check.

Mr. ROUSSELOT. Bill, I think I can answer that question. The only disagreement has been, as I recall and if my colleague wants to respond further, is if you do it in 1 year, 2 years, or 3 years reduce marginal tax rates. Isn't that right?

Senator BRADLEY. That is one of the areas of disagreement. Does that make a difference?

Mr. ROUSSELOT. Well, to some it seems to. My Democratic leaders think so. You would think the whole world was going to come to an end if we have 3 years of tax reductions. I don't understand them.

Senator BRADLEY. Does it make a difference to you?

Mr. ROUSSELOT. Well, of course, it makes a difference to me or I wouldn't be here.

Senator BRADLEY. Why, then, is there a disagreement in your own party as to whether it should be 1 year or 3 years?

Mr. ROUSSELOT. In our party we never marched lock step. We are individuals. We have different opinions.

Senator BRADLEY. Come, come, Congressman.

Senator SYMMS. They are too conservative. We need some guys who want to dump tea in the harbor to get this thing straightened out. That is the problem.

Mr. ROUSSELOT. We are working on it. We think President Reagan dumped the tea in the harbor in the last election and said very clearly, tax rates are too high for individuals and we think they should be reduced. Then he followed with a specific proposal. Reduce them over 3 years.

Senator BRADLEY. Let me just say that reduction of marginal tax rates is the key and one of the things——

Mr. ROUSSELOT. A major key. I don't think it is the only one.

Senator BRADLEY. And one of the things that I have a problem with is understanding why you don't have unanimity. Maybe it is as Steve says because there is a traditional pull within your party.

Mr. ROUSSELOT. Let me say that in the Ways and Means Committee all 12 of us, even though we didn't get our proportionate increase in numbers that we should have had——

Senator BRADLEY. I was——

Mr. ROUSSELOT. If you need some help with Mr. Guerini, I will be glad to deliver a message to him that you are for him.

Senator BRADLEY. I was thinking, Congressman, that maybe we ought to reduce the marginal tax rates not to 50 percent, but to 30 percent and in the process eliminate all the tax expenditures. Is that something you could support?

Mr. ROUSSELOT. Oh, I would in a minute.

Senator BRADLEY. You would.

Mr. ROUSSELOT. Certainly. Move it. I don't know how many other votes——

The CHAIRMAN. You would have to have a hearing on that.

Mr. ROUSSELOT. Yes. Let me say, I have never been a believer in high tax rates, but I am not typical.

Senator BRADLEY. You would be a cosponsor of a reduction? You are committing yourself today on the record. Cosponsoring reducing the marginal tax rate down to 30 percent and eliminating all tax expenditures.

Mr. ROUSSELOT. I have a constitutional amendment which would abolish the income tax. Do you want to join me in that?

Senator BRADLEY. I can't——

Mr. ROUSSELOT. I mean if you want to go tough. Mr. Symms used to cosponsor it with me.

The CHAIRMAN. Well, he has moderated over here.

Mr. ROUSSELOT. He has moderated over here. What I am saying to you, Senator, you can't push me far enough.

The CHAIRMAN. I know you are very busy and I don't want to take any more of your time.

Mr. ROUSSELOT. Or any more of my ideas.

The CHAIRMAN. Right. We have enough over here. We are glad you came over again and we would like to have you back. We will let you know.

Mr. ROUSSELOT. You'll call me, right.

The CHAIRMAN. Yes, we will call you. Thank you very much, John.

Mr. ROUSSELOT. Thank you.

The CHAIRMAN. We now have a panel consisting of Harry Gourevitch, Congressional Research Service and Dr. William Freund, Senior Vice President and Chief Economist, New York Stock Exchange.

Senator PACKWOOD. Mr. Gourevitch, do you want to go first?

STATEMENTS OF HARRY GOUREVITCH, CONGRESSIONAL RESEARCH SERVICE

Mr. GOUREVITCH. Mr. Chairman, members of the committee, I welcome this opportunity to report to you on a study we have prepared, at Senator Packwood's request, comparing tax burdens on households at different income levels in the United States and six other industrial countries.

If I may, I will ask that a copy of the report be inserted into the record and I will confine myself to a brief summary of the highlights of the report.

Senator PACKWOOD. The report will be put in the record.

[Material referred to follows:]

Congressional Research Service
The Library of Congress

Wasnington DC 20540

INDIVIDUAL TAX BURDENS IN THE UNITED STATES AND OTHER INDUSTRIAL COUNTRIES

by
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Senior Specialist in Taxation and Fiscal Policy
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April 30, 1981

ERRATA

In Appendix I, on page 42, footnote 5 for the United Kingdom should read:

5/ Interest on $2,400 of National Savings Certificates is exempt from tax; it is assumed that these pay 10 percent interest. $170 of interest from a postal savings account is also exempt. Therefore, at every income level, it is assumed that $410 of interest is exempt.

The tables on pages 42 and 44, showing the tax burden on interest in the United Kingdom, should be corrected to show this information:

Gross Income	Total Tax Burden		Marginal Rate on Last $1,000 Received	
	In U.S. Dollars	Percentage	In U.S. Dollars	Percentage
$5,000	0	0	0	0
$10,000	1,353	13.5	300	30.0
$20,000	4,050	20.3	300	30.0
$50,000	20,618	41.2	650	65.0
$100,000	46,590	46.6	750	75.0

Chart 5, on page 14, should show the United Kingdom with these rankings and percentages:

$5,000: fifth, at 0 percent.
$10,000: second, at 13.5 percent.
$20,000: first, at 20.3 percent.
$50,000: first, at 41.2 percent.
$100,000: first, at 46.6 percent.

Table 5, on page 15, should also be changed to reflect the corrections above.

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Introduction and Summary

This study compares the tax burdens on households at different income levels in the United States, Canada, France, the Federal Republic of Germany, Italy, Japan, and the United Kingdom. The study does not analyze the effect of differences in household tax burdens among these countries on their economic performance.

The study is based on a hypothetical family of four at the following income levels: $5,000, $10,000, $20,000, $50,000, $100,000. In computing tax burdens at each income level it is assumed that the entire amount of income is derived solely from a single source such as wages, dividends, interest or long-term capital gains, rather than that at each level income is derived from each of these sources in varying proportions. For reasons of convenience it has not been assumed that a household's income consists of a combination of wages, dividends and/or interest, and capital gains. Such a design was used by a 1981 New York Stock Exchange study, U.S. Economic Performance in Global Perspective, in comparing tax burdens in the United States and several other countries on an individual with wage income of $50,000, dividends of $10,000, interest of $5,000, and capital gains of $34,000.*/

Income amounts at each level are expressed as amounts of gross income, not taxable income. Thus, in computing tax burdens on taxable income from wages, dividends, interest or long-term capital gains, deductions have been taken for appropriate exemptions and standard or itemized deductions. Assumptions relied on in taking these deductions are spelled out in footnotes to the appropriate tables in Appendix I.

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*/ The N.Y. Stock Exchange study is based on a separate study, Tax Policy Incentives to Capital Formation, prepared for it by Price Waterhouse & Co.

Tax burdens at each income level are expressed separately as amounts of effective taxes, effective tax rates, amounts of marginal taxes and marginal rates. Effective taxes are the amounts of tax paid on total income. Marginal taxes are the amounts of tax paid on incremental income.

Tax Burdens on Wage Income. As to each country taxes covered include the Federal or national income tax, national social security taxes, and national sales and other consumption taxes.*/ State, provincial and other local taxes are not covered. National wealth taxes, such as Germany's net worth tax, are also not covered.

The results on Chart 1 and Table 1 show that on wage income of $5,000, the total effective tax burden (i.e., income taxes, plus social security taxes, plus consumption taxes) is lowest in the United States and highest in France. At that income level there is a refund of tax in the United States due to the earned income credit. At the $10,000 income level, the lowest effective tax burden is in Canada and the second lowest in the United States, while the highest is in the United Kingdom. At income of $20,000, the U.S. total tax burden is the third lowest; at income levels of $50,000 and $100,000, the effective U.S. tax burdens are exactly at the median, in three of the countries total effective tax burdens being higher (United Kingdom, Germany, Italy), and in three of them total effective tax burdens being lower (Canada, France, Japan). We have not compared total marginal tax rates, as we do not have data on marginal consumption tax rates.

Chart 2 and Table 2 compare the combined income and social security tax burdens on wage income, and leave out consumption taxes. They show that the United States' effective income and social security tax burdens place it in sixth place with the second lowest taxes at $5,000 and $10,000 income levels, and in fourth place at the higher income levels.

---

*/ For an explanation of the methodology used in computing consumption taxes, see Appendix II.

Chart 1.

WAGE INCOME – INCOME TAXES, SOCIAL SECURITY TAXES & CONSUMPTION TAXES

(Percentage of Gross Income)

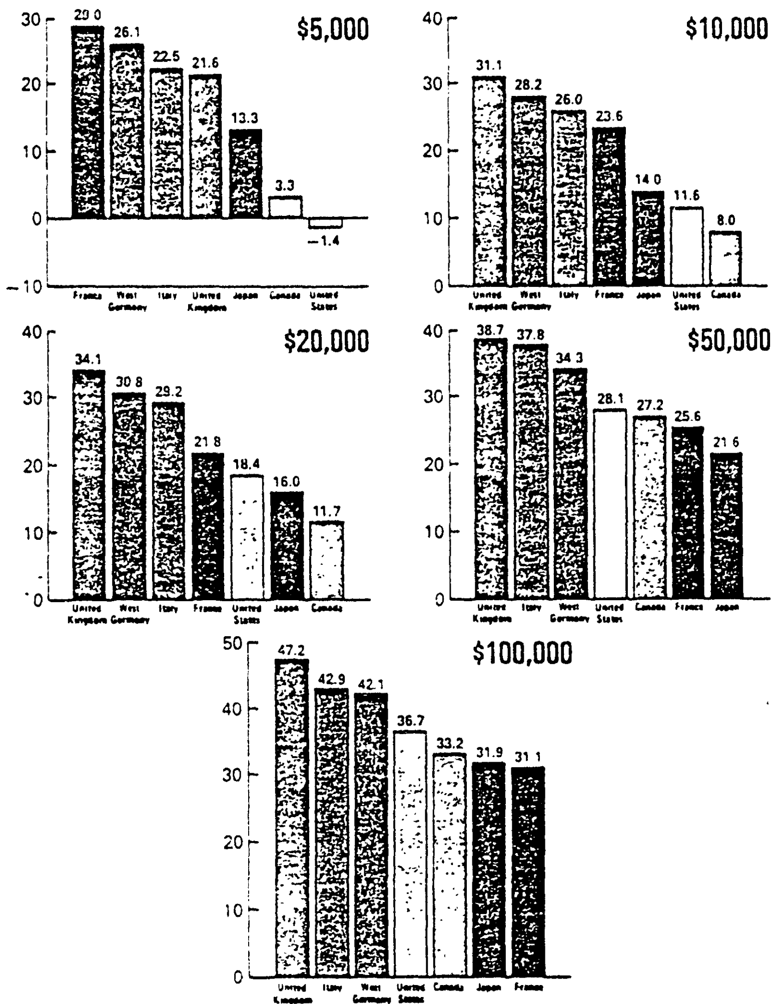

Table 1

Wage Income: Income Tax, Social Security Taxes, and Consumption Taxes

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	165	1,453	1,303	1,127	666	1,085	(-70)
$10,000	798	2,365	2,836	2,602	1,406	3,104	1,163
$20,000	3,026	4,378	6,161	5,821	3,191	6,813	3,682
$50,000	13,605	12,782	17,138	18,876	10,821	19,368	14,047
$100,000	33,240	31,015	42,127	42,849	31,933	47,201	36,626

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	3.3	29.0	26.1	22.5	13.3	21.6	(-1.4)
$10,000	8.0	23.6	28.2	26.0	14.0	31.1	11.6
$20,000	11.7	21.8	30.8	29.2	16.0	34.1	18.4
$50,000	27.2	25.6	34.3	37.8	21.6	38.7	28.1
$100,000	33.2	31.1	42.1	42.9	31.9	47.2	36.7

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Chart 2.

WAGE INCOME – INCOME TAXES & SOCIAL SECURITY TAXES

(Percentage of Gross Income)

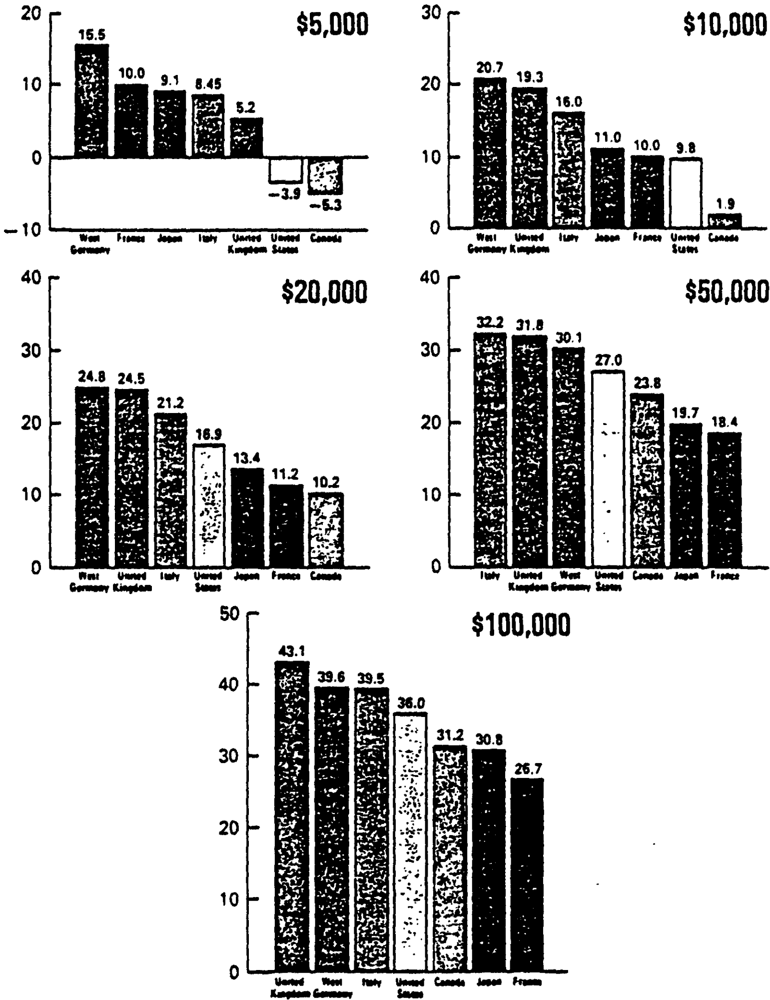

Table 2

Wage Income: Income Tax and Social Security Taxes

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-262)	502	775	425	455	261	(-193)
$10,000	187	1,004	2,071	1,598	1,105	1,927	987
$20,000	2,049	2,255	4,959	4,225	2,685	4,902	3,386
$50,000	11,881	9,162	15,027	16,082	9,869	15,929	13,491
$100,000	31,206	26,642	39,591	39,491	30,804	43,089	35,966

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-5.3)	10.0	15.5	8.45	9.1	5.2	(-3.9)
$10,000	1.9	10.0	20.7	16.0	11.0	19.3	9.8
$20,000	10.2	11.2	24.8	21.2	13.4	24.5	16.9
$50,000	23.8	18.4	30.1	32.2	19.7	31.8	27.0
$100,000	31.2	26.7	39.6	39.5	30.8	43.1	36.0

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	3.2	10.0	15.5	12.7	9.1	4.0	(-3.9)
$10,000	19.9	10.0	34.9	28.4	9.1	34.0	33.6
$20,000	20.3	14.6	32.3	31.2	21.4	30.0	27.7
$50,000	37.1	31.3	43.5	44.6	34.6	50.0	44.3
$100,000	43.0	51.7	53.8	50.2	54.6	60.0	50.0

Chart 3 and Table 3 compare the income tax burdens on wage income, and leave out both social security and consumption taxes. They show that at the $5,000 income level none of the countries except Italy imposes an effective or marginal income tax burden. Italy's effective rate on $5,000 of gross income is a nominal 1 percent and its marginal rate 5.2 percent. Both the United States and Canada offer tax refunds at this level. At the $10,000 income level, Canada still offers a refund, France and Japan exempt such income from tax and the U.S. effective rate is at the median. At income levels of $20,000, $50,000 and $100,000 U.S. effective income tax burdens are third highest, two countries imposing heavier income tax burdens, and four imposing lighter income tax burdens. Table 3 shows that at the $20,000 income level the U.S. marginal tax rate is also at the median; at the $50,000 income level the U.S. marginal rate is second highest after the United Kingdom; at the $100,000 income level the U.S. marginal rate is tied with Japan for the third highest rate behind the United Kingdom and Germany.

In comparing income tax burdens, it should be noted that the United States, Japan and the United Kingdom do not allow any deduction for social security taxes paid in arriving at taxable income, France and Canada allow a full deduction for social security taxes paid, and Germany allows a full deduction up to a specified ceiling.

It should also be noted that differences in country rankings sometimes are due to minor differences of less than 1 percent in national tax burdens. Still, the results indicate that international comparisons of tax burdens on the wage income of households vary to some extent depending on whether the comparisons include income, social security and consumption taxes, or income and social security taxes only, or income taxes only. If one compares total tax burdens (i.e., income, social security and consumption taxes), U.S. effective rates are

Chart 3.

INCOME TAXES ON WAGE INCOME

(Percentage of Gross Income)

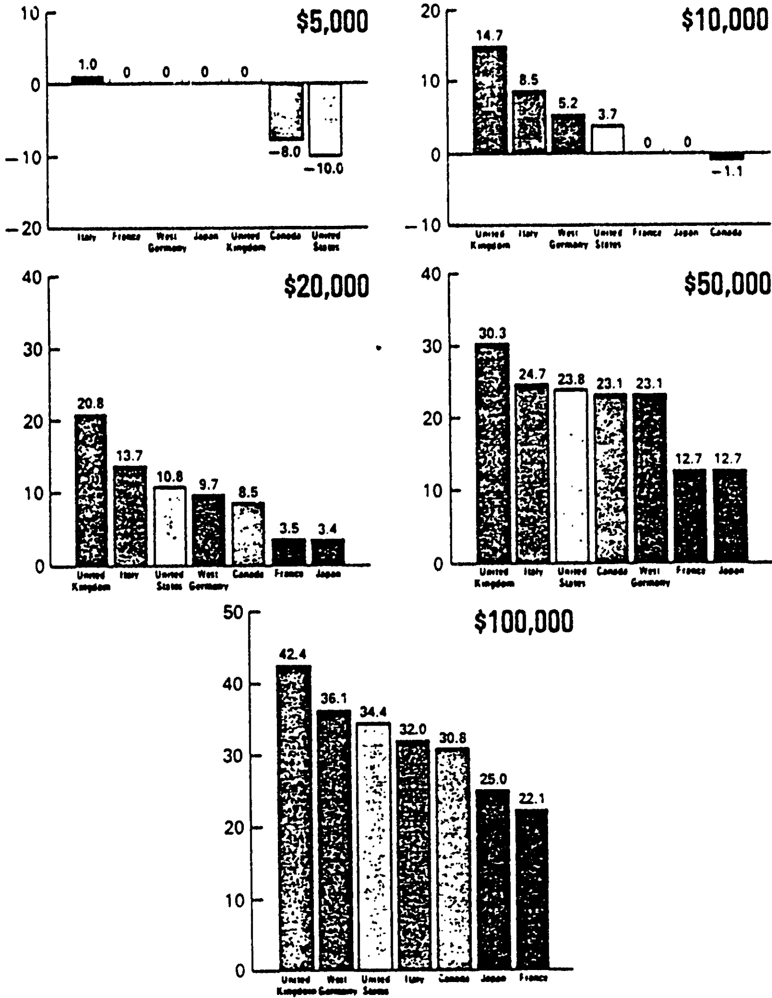

Table 3

Wage Income: Income Tax

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-400)	0	0	52	0	0	(-500)
$10,000	(-108)	0	521	853	0	1,466	374
$20,000	1,700	709	1,939	2,735	670	4,170	2,160
$50,000	11,532	6,334	11,534	12,357	6,375	15,197	11,903
$100,000	30,822	22,064	36,098	32,041	25,035	42,357	34,378

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-8.0)	0	0	1.0	0	0	(-10.0)
$10,000	(-1.1)	0	5.2	8.5	0	14.7	3.7
$20,000	8.5	3.5	9.7	13.7	3.4	20.8	10.8
$50,000	23.1	12.7	23.1	24.7	12.7	30.3	23.8
$100,000	30.8	22.1	36.1	32.0	25.0	42.4	34.4

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	0	0	0	5.2	0	0	(-10.0)
$10,000	16.7	0	19.4	20.9	0	30.0	27.5
$20,000	20.3	10.3	21.8	28.7	12.3	30.0	21.6
$50,000	37.1	27.8	43.5	37.1	30.0	50.0	44.3
$100,000	43.0	48.2	53.8	42.7	50.0	60.0	50.0

lower than those of Germany at each income level, and they are also lower than those of Japan at the $5,000 and $10.000 income levels, but higher than those of Japan at the $20,000, $50,000 and $100,000 income levels. The same results obtain when the comparisons include income and social security taxes but omit consumption taxes. The picture changes somewhat when comparing income taxes only, as then U.S. effective rates are higher than those of both Germany and Japan at $20,000 and $50,000. At $100,000, U.S. effective rates are higher than Japan's but lower than Germany's.

Tax Burdens on Investment Income.

Dividend Income. Chart 4 and Table 4 show that on $5,000 of dividend income none of the countries imposes either effective or marginal taxes, and all but Japan and the United States give individuals a tax refund. All of these countries other than the United States partially integrate corporate and shareholder income taxes and give shareholders a tax credit with dividend distributions. The dividend tax credit is refundable if it exceeds tax liability in France, Germany, Italy and the United Kingdom; it is not refundable in Canada and Japan. While Chart 4 and and Table 4 show Canada giving a tax refund on dividend income levels of $5,000, $10,000 and $20,000, this is because of Canada's refundable child credit. It should be noted that these comparisons of dividend taxation describe tax burdens on corporate income only at the shareholder level, not also at the corporate level.

On $100,000 of dividend income, the highest effective tax and also the highest marginal tax is imposed by the United Kingdom; second highest effective and marginal taxes are imposed by the United States; third highest effective and marginal taxes are imposed by Japan. The lowest effective and marginal taxes on $100,000 of dividend income are imposed by Canada, the second lowest by Germany. The high effective and marginal rates in the United Kingdom are due to its 15% tax surcharge on dividends or interest in excess of $13,150. The amount subject to this surcharge is reduced by the amount of deductible mortgage interest paid.

Chart 4.

DIVIDEND INCOME

(Percentage of Gross Income)

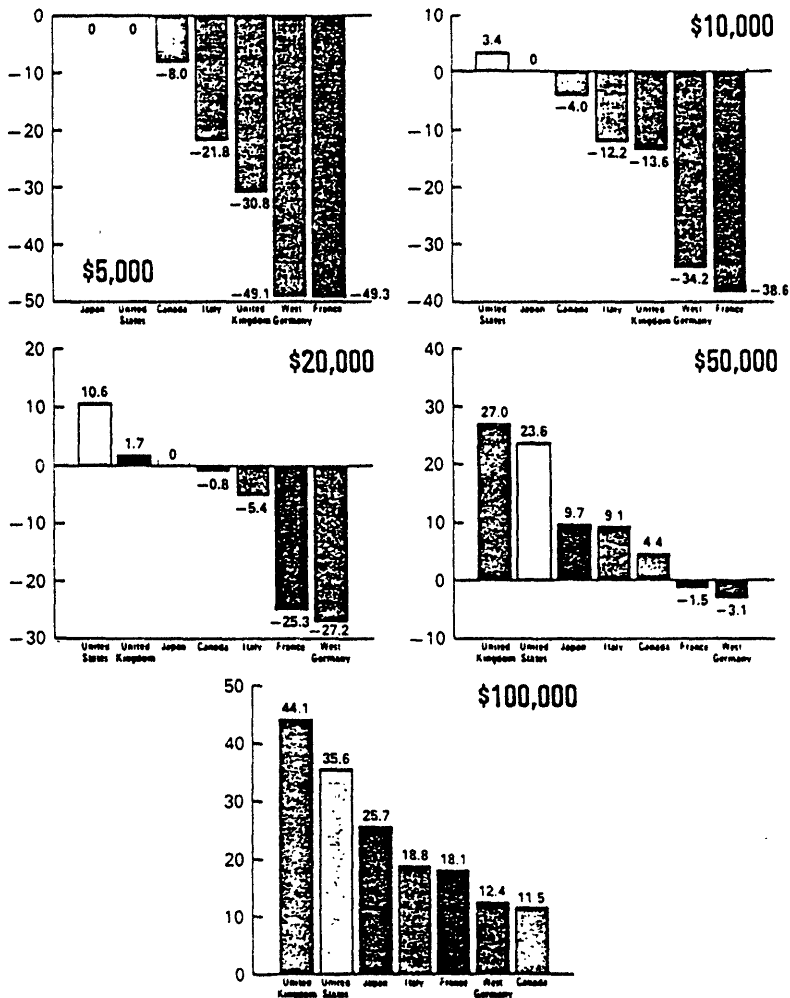

Table 4

Dividend Income

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-400)	(-2,463)	(-2,457)	(-1,092)	0	(-1,538)	0
$10,000	(-400)	(-3,856)	(-3,425)	(-1,222)	0	(-1,364)	342
$20,000	(-168)	(-5,065)	(-5,443)	(-1,084)	0	331	2,117
$50,000	2,200	(-743)	(-1,560)	4,553	4,851	13,484	11,814
$100,000	14,797	18,094	12,379	18,807	25,656	44,075	35,626

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-8.0)	(-49.3)	(-49.1)	(-21.8)	0	(-30.8)	0
$10,000	(-4.0)	(-38.6)	(-34.2)	(-12.2)	0	(-13.6)	3.4
$20,000	(-0.8)	(-25.3)	(-27.2)	(-5.4)	0	1.7	10.6
$50,000	4.4	(-1.5)	(-3.1)	9.1	9.7	27.0	23.6
$100,000	11.5	18.1	12.4	18.8	25.7	44.1	35.6

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	0	(-46.3)	(-35.3)	(-9.6)	0	(-0.1)	0
$10,000	0	(-20.4)	(-19.5)	(-3.6)	0	17.4	14.6
$20,000	4.6	2.5	(-2.4)	12.1	0	21.4	21.9
$50,000	20.9	25.0	24.5	25.4	5.8	57.1	44.2
$100,000	26.9	40.0	31.1	33.5	44.9	64.4	59.0

Interest Income. Chart 5 and Table 5 show that on $5,000 of interest income only Italy taxes such income. Italy taxes such income with a flat-rate 20% withholding tax. On interest income of $100,000, the highest effective rate is imposed by the United Kingdom and the third highest by the United States. On interest income of $10,000, $20,000 and $50,000, the United States effective rate is at the median of the distribution.

It should be noted that only interest from savings accounts or other similar savings plans was considered. Other types of interest, such as from bonds, were not considered. The tax burden on interest often varies in a country depending on the source of the interest. In Japan and France, for example, a taxpayer may elect a final withholding tax on certain types of interest, rather than paying a tax at a graduated income tax rate. Most countries also offer a tax exemption for at least a limited amount of interest from certain sources. The United Kingdom exempts from tax interest from Postal Savings certificates; Japan exempts interest from several different sources; France allows the interest from a certain amount deposited in a national savings institution to go untaxed. This study has assumed that taxpayers in those countries receive certain specified amounts of interest tax-free (See Appendix I). Although the United States does not tax interest from municipal bonds, as noted above bond interest has been excluded.

Chart 5

INTEREST INCOME

(Percentage of Gross Income)

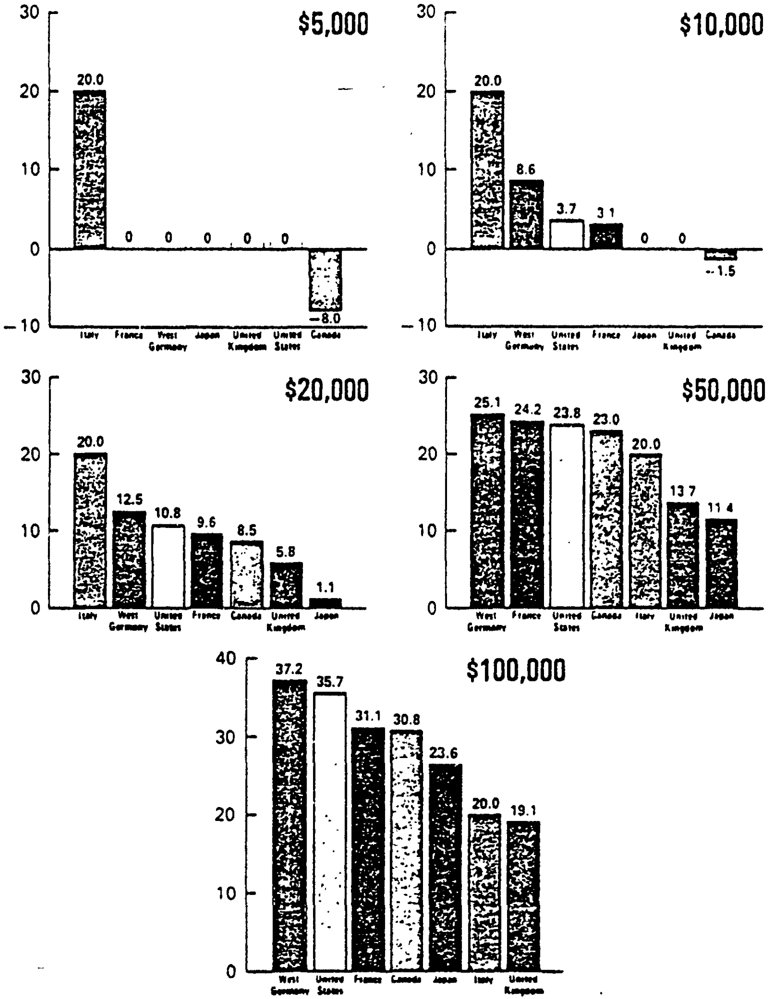

Table 5

Interest Income

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-400)	0	0	1,000	0	0	0
$10,000	(-149)	308	861	2,000	0	0	374
$20,000	1,690	1,919	2,508	4,000	229	1,166	2,160
$50,000	11,515	12,093	12,545	10,000	5,678	6,854	11,903
$100,000	30,791	31,093	37,206	20,000	23,594	19,133	3[illegible],744

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-8.0)	0	0	20	0	0	0
$10,000	(-1.5)	3.1	8.6	20	0	0	3.7
$20,000	8.5	9.6	12.5	20	1.1	5.8	10.8
$50,000	23.0	24.2	25.1	20	11.4	13.7	23.8
$100,000	30.8	31.1	37.2	20	23.6	19.1	35.7

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	0	0	0	20.0	0	0	0
$10,000	17.5	15.0	21.8	20.0	0	0	15.0
$20,000	21.6	25.0	22.9	20.0	10.0	15.0	21.6
$50,000	37.1	38.0	44.7	20.0	27.6	22.5	44.3
$100,000	43.0	38.0	54.0	20.0	35.0	32.5	59.0

Capital Gains. Chart 6 and Table 6 show that on $5,000 of long-term capital gains from a sale of securities the gain is taxed only in France. France imposes a flat-rate of 15% on long-term capital gains from a sale of securities, regardless of the amount of the gain, provided that the sales proceeds for the year exceed $33,225. In Chart 6 and Table 6 it is assumed that on a long-term capital gain of $5,000, in France the sales proceeds during the year exceeded $33,225. On long-term capital gains of $100,000, the highest effective rate is imposed by the United Kingdom, the next highest by France; the highest marginal rate is also imposed by the United Kingdom though the next highest marginal rate is imposed by the United States. Long-term capital gains on a sale of securities are exempt from tax in Germany, Italy and Japan. Canada exempts from tax 50 percent of long-term capital gains and the United States exempts 60 percent. In the United States long-term capital gains of $5,000, $10,000 and $20,000 are exempt from tax, while such gains at the $50,000 and $100,000 levels are subject to tax. Capital gains at the $20,000 income level are exempt due to the 60 percent capital gains deduction and certain assumed deductions described in Appendix I. The taxes at the $50,000 and $100,000 levels consist of amounts imposed by the alternative minimum tax on capital gains.

Chart 6.

LONG-TERM CAPITAL GAINS

(Percentage of Gross Income)

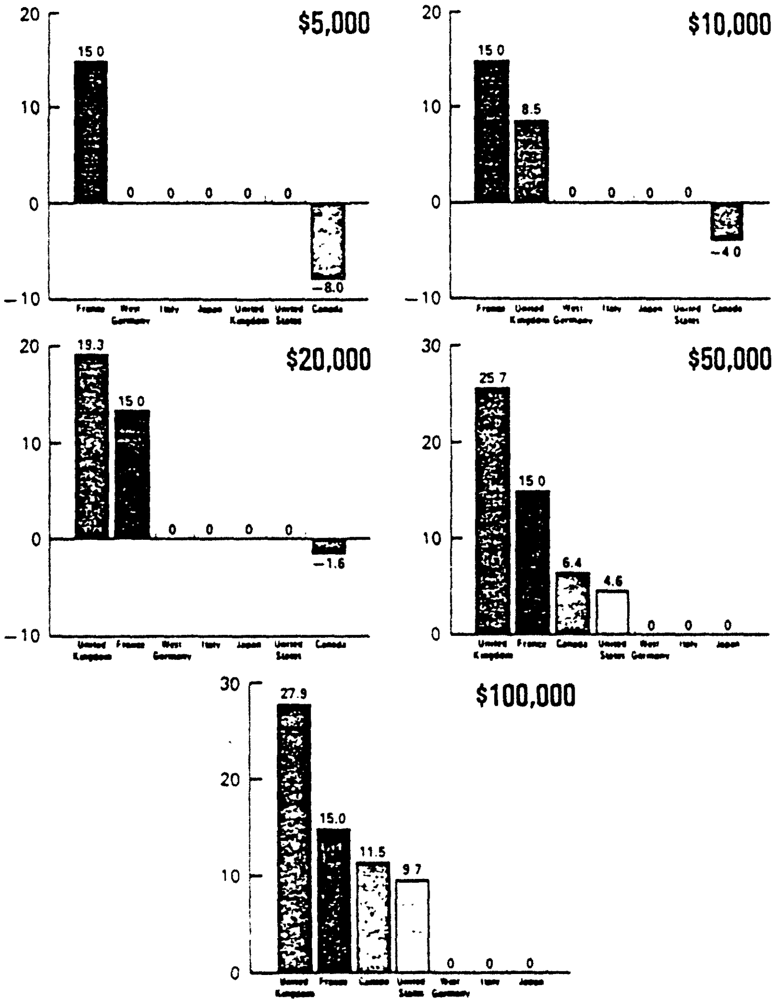

Table 6

Long-Term Capital Gains

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-400)	750	0	0	0	0	0
$10,000	(-400)	1,500	0	0	0	853	0
$20,000	(-319)	3,000	0	0	0	3,857	0
$50,000	3,208	7,500	0	0	0	12,870	2,300
$100,000	11,515	15,000	0	0	0	27,891	9,720

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	(-8.0)	15.0	0	0	0	0	0
$10,000	(-4.0)	15.0	0	0	0	8.5	0
$20,000	(-1.6)	15.0	0	0	0	19.3	0
$50,000	6.4	15.0	0	0	0	25.7	4.6
$100,000	11.5	15.0	0	0	0	27.9	9.7

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	0	15.0	0	0	0	0	0
$10,000	0	15.0	0	0	0	30.0	0
$20,000	8.1	15.0	0	0	0	30.0	0
$50,000	15.6	15.0	0	0	0	30.0	10.1
$100,000	18.5	15.0	0	0	0	30.0	20.3

ANALYSIS

Considerable caution needs to be exercised in using these tax comparisons to draw conclusions with respect to the different levels of savings and investment in various countries.

The first and most obvious limitation is that savings and investment levels are functions of numerous social, cultural, political, and economic factors of which tax policy is only one, perhaps minor, element. As only one example, the role of government differs substantially in the countries; in some the government has substantial direct ownership of business, exercises direct influence in the allocation of financial capital in the economy, and engages in detailed economic planning. In these countries levels of savings and investment are much more directly affected by government policy than in the U.S.

International comparisons of relative tax levels are also of limited usefulness absent detailed information on other economic relationships within a country. For example, the structure and organization of capital markets and the types of financial instruments available to savers and investors are important. If tax incentives for savings in another country are larger than in the U.S., but savers in that country receive lower real after-tax returns on their savings, what conclusion should be drawn about savings incentives? The structure of financial institutions may also play an important role in investment. Most corporate investment in Japan is financed through bank loans which are influenced more strongly by government policy than in the U.S., whereas in this country the largest source of external finance for corporate investment is the sale of bonds. What effects do these different financial practices have on the level of investment and to what extent does tax policy play a role?

Moreover, in order to obtain a complete picture of a government's tax policy towards savings, it is necessary to look not only at the tax treatment of dividends, interest and capital gains, but also at the deductibility or nondeductibility of various forms of interest payments. For example, mortgage interest is not deductible at all in Japan and Canada, and the deduction is subject to limits in France, the Federal Republic of Germany, Italy and the United Kingdom. Similarly, interest on consumer debt is nondeductible in all the countries surveyed except the United States. Restrictions on the deductibility of mortgage and consumer interest may encourage individuals to save first and buy later.

It must also be remembered that taxes are only one side of the government budget; the effect of the government on savings and investment is a function of not only tax policy but also expenditure policy as well as the aggregate difference between taxes and spending, the deficit or surplus. Some types of government expenditure, for example, construction of basic infrastructure, contribute directly to a nation's investment and facilitate private sector investment. Hence, it is possible that higher taxes used to finance these investment related expenditures could be stimulants to higher private investment. It is also true that a government budgetary surplus provides capital to the financial markets for investment, whereas a deficit withdraws capital. Therefore, for a given level of government expenditure, higher taxes can be associated with greater incentives for private investment by essentially providing "forced savings" to the capital markets.

There are also limitations to interpreting the accompanying tax data resulting from the fact that they do not take account of differing income distributions within the countries. Of the countries surveyed, income per

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capita in 1979 expressed in U.S. dollars ranges from $5,620 in Italy to $12,400 in West Germany,*/ indicating that a family income level of, for example, $20,000 does not represent the same position in the income distribution of the various countries. Although adjustments of household tax burdens for differences in per capita income and the distribution of income in each country are beyond the scope of this study, such adjustments may be necessary if one is to obtain valid information from comparisons of household tax burdens.

An additional important limitation of the tax data is that they represent only the taxes levied by the central government in each country. However, since the structure of government differs substantially in the countries, central and local tax levels represent differing proportions of the total tax burden in each country. For example, the central government collects slightly over half of the total tax revenues in Canada, and about 64 percent in the U.S., whereas in Italy the central government collects virtually all of the nation's taxes and in France the central government collects over 90 percent of total tax revenues. Whatever effects taxes have on the level of savings and investment in the countries, the effects presumably result from the total tax burden, not just taxes paid to the central government.

Still another complication relates to the differences among countries in tax administration and collection. These differences may take on particular significance for types of income that are not subject to withholding of tax at the source. While all the countries surveyed except France withhold income tax on wage income, only the United States and Canada do not withhold on

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*/ National Foreign Assessment Center, Central Intelligence Agency, Handbook of Economic Statistics 1980, October 1980. Table 1, p. 10.

either dividends or interest. There is withholding on both dividends and interest in Germany (interest withholding only on convertible bonds and profit-sharing bonds), Italy and Japan. In addition, there is interest, but not dividend, withholding in France (interest on bonds but not on bank deposits) and the United Kingdom.

These several limitations suggest that the accompanying tax data cannot be used directly to draw conclusions about the causes of different levels of savings and investment, or even the different effects of tax policy, in the various countries. However, if carefully interpreted, the data can make a contribution toward an overall understanding of the different government policies and economic circumstances that exist in the different countries.

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Appendix I

TAX BURDENS ON WAGES, INTEREST, DIVIDENDS, AND LONG-TERM CAPITAL GAINS, IN THE FOLLOWING COUNTRIES:

The United States, Canada, France, Federal Republic of Germany, Italy, Japan, and the United Kingdom.

Assumptions Applicable to All Countries

Calculations were made for a family of four. All income is received by one spouse, unless otherwise noted.

The family is assumed to have certain expenses. The tax treatment of these expenses is described for each country, and these amounts have been taken as deductions in the countries where allowed.

Real Estate Taxes

Income Level	Amount
$100,000	$4,000
50,000	2,000
20,000	1,000

Mortgage Interest

Income Level	Amount
$100,000	$4,000
50,000	2,000
20,000	1,000

Families at the $10,000 and $5,000 income levels are assumed not to own a home.

Interest on Household, Personal Expenditures

Income Level	Amount
$100,000	$2,000
50,000	1,000
20,000	500
10,000	0
5,000	0

Medical Expenses

Income Level	Amount
$100,000	$2,000
50,000	2,000
20,000	2,000
10,000	1,000
5,000	500

Consumption tax burdens are estimates, based on United States consumption tax burden data adjusted so as to be representative of levels of consumption taxes in the other countries. Unlike the income tax and social security tax data, they are not derived from an application of each nation's tax laws on a taxpayer with assumed characteristics. A full explanation of the methodology used in computing the consumption tax burdens is presented in Appendix II. Estimates of marginal consumption tax burdens were not prepared.

Interest income is from savings accounts or other similar savings plans.

Dividend income is from corporations in the same country as the taxpayer.

Long-term capital gains are from the sale of stock in corporations in the same country as the taxpayer. The taxpayer is not a dealer or speculator in stocks. The proceeds of the sale are reinvested.

These computations are only for national taxes; local and state taxes have been disregarded.

UNITED STATES

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest	Dividends 5/	Long Term Capital Gains 6/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	(-500)	307	123	(-70)	0	0	0
$10,000	374	613	176	1,163	374	342	0
$20,000	2,160	1,226	296	3,682	2,160	2,117	0
$50,000	11,903	1,588	556	14,047	11,903	11,814	2,300
$100,000	34,378	1,588	660	36,626	35,744	35,626	9,720

1/ Tax rates are for income received in 1980. The income tax rates range from 14 percent of taxable income between $3,400 and $5,500, to 70 percent of taxable income in excess of $215,400.

2/ Itemized deductions are allowed to all taxpayers for real estate taxes, mortgage interest, general interest, and medical expenses (in excess of 3 percent of adjusted gross income), but only insofar as the total amount exceeds $3,400. A family of four is allowed a deduction for personal exemptions of $4,000.

3/ A refundable earned income credit of 10 percent is allowed on the first $5,000 of earned income; the percentage tapers off to zero as total earned income reaches $10,000. A maximum tax rate of 50 percent applies to taxable earned income in excess of $60,000.

4/ Social Security taxes for 1980 are levied at 6.13 percent of the first $25,900 wages. These are only the employee's contributions.

5/ It is assumed that the spouses jointly own the stocks; an exemption of $200 of dividend income is allowed in computing gross income.

6/ A deduction of 60 percent of net capital gains is allowed in computing adjusted gross income. All gain is assumed to arise from the sale of stock. The alternative minimum tax (Internal Revenue Code section 55) has been included in all computations to which it applies.

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UNITED STATES

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	(-10.0)	6.13	2.5	(-1.4)	0	0	0
$10,000	3.7	6.13	1.8	11.6	3.7	3.4	0
$20,000	10.8	6.13	1.5	18.4	10.8	10.6	0
$50,000	23.8	3.2	1.1	28.1	23.8	23.6	4.6
$100,000	34.4	1.59	0.7	36.7	35.7	35.6	9.7

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	(-100)	61.30	(-39.70)	0	0	0
$10,000	275[1/]	61.30	336.30	150	146	0
$20,000	216	61.30	277.30	216	219	0
$50,000	443	0	443	443	442	101
$100,000	500	0	500	590	590	203

1/ An earned income credit of $125 is allowed to a taxpayer with one or more children receiving $9,000 of wages; a taxpayer with $10,000 of wages is not allowed any earned income credit.

UNITED STATES

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	(-10.0)	6.13	(-3.9)	0	0	0
$10,000	27.5	6.13	33.6	15.0	14.6	0
$20,000	21.6	6.13	27.7	21.6	21.9	0
$50,000	44.3	0	44.3	44.3	44.2	10.1
$100,000	50.0	0	50.0	59.0	59.0	20.3

CANADA

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest 5/	Dividends 6/	Long Term Capital Gains 7/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	(-400)	138	427	165	(-400)	(-400)	(-400)
$10,000	(-108)	295	611	798	(-149)	(-400)	(-400)
$20,000	1,700	349	977	3,026	1,690	(-168)	(-319)
$50,000	11,532	349	1,724	13,605	11,515	2,200	3,208
$100,000	30,822	349	2,069	33,240	30,791	14,797	11,515

1/ Tax rates are for income received in 1980. The income tax rates range from 6 percent on taxable income of not more than $760, to 43 percent on taxable income of more than $91,000. The exchange rate on December 31, 1980 was $1 U.S. to 1.19 Canadian dollars.

2/ Taxpayers may take a standard deduction for medical expenses of $84, or deduct actual expenses in excess of 3 percent of adjusted gross income. Real estate taxes, mortgage interest, and general interest are not deductible. A family of four, filing a single return, may deduct personal allowances of $5,460: $2,430 for the taxpayer, $2,130 for the spouse, and $450 for each dependent.

Each taxpayer may reduce his tax by 9 percent of the gross amount of tax liability: the minimum reduction is $168, and the maximum reduction is $420. A taxpayer with two children is entitled to a refundable tax credit of $400; the credit is reduced when taxable income reaches $17,960, and no credit is allowed when taxable income exceeds $25,960.

3/ In computing adjusted gross income from employment, a taxpayer may deduct social security contributions. The taxpayer may also deduct 3 percent of wages, up to $420.

4/ An employee's social security contributions for 1980 amounted to:

Canadian Pension Plan Act: 1.8 percent of the first $11,000 of wages, with a basic exemption of $1,100 of wages;
Unemployment Insurance: 1.35 percent of the first $244 of wages per week ($12,670 per year).

Canada

(Continued)

5/ A taxpayer may deduct a total of $840 of adjusted gross income from interest, dividends, and capital gains in computing taxable income.

6/ In computing adjusted gross income from dividends, the taxpayer must increase the amount received by 50 percent, to account for the corporation tax paid by the distributing corporation. Seventy-five percent of the increase may be applied as a non-refundable tax credit, after the basic 9 percent reduction in tax is made.

In computing taxable income, a taxpayer may deduct a total of $840 of adjusted gross income from dividends, interest, and capital gains.

7/ In computing adjusted gross income from capital gains, 50 percent of the gain is excluded. In computing taxable income, a taxpayer may deduct a total of $840 of adjusted gross income from capital gains, interest and dividends.

CANADA

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	(-8.0)	2.75	8.5	3.3	(-8.0)	(-8.0)	(-8.0)
$10,000	(-1.08)	2.95	6.1	8.0	(-1.5)	(-4.0)	(-4.0)
$20,000	8.5	1.7	4.9	11.7	8.5	(-0.8)	(-1.6)
$50,000	23.1	0.7	3.4	27.2	23.0	4.4	6.4
$100,000	30.8	0.3	2.1	33.2	30.8	14.8	11.5

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	31	31	0	0	0
$10,000	167	31	198	175	0	0
$20,000	203	0	203	216	46	81
$50,000	371	0	371	371	209	156
$100,000	430	0	430	430	269	185

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	3.15	3.15	0	0	0
$10,000	16.7	3.15	19.85	17.5	0	0
$20,000	20.3	0	20.3	21.6	4.6	8.1
$50,000	37.1	0	37.1	37.1	20.9	15.6
$100,000	43.0	0	43 0	43.0	26.9	18.5

FRANCE

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest 5/	Dividends 6/	Long Term Capital Gains 7/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	0	502	951	1,453	0	(-2,463)	750
$10,000	0	1,004	1,361	2,365	308	(-3,856)	1,500
$20,000	709	1,546	2,123	4,378	1,919	(-5,065)	3,000
$50,000	6,334	2,829	3,620	12,782	12,093	(- 743)	7,500
$100,000	22,064	4,578	4,373	31,015	31,093	18,094	15,000

1/ Tax rates are for income received in 1980, except for Social Security tax rates, which are for 1979. For a family of four, the income tax rates range from 5 percent on taxable income between $6,570 and $6,870, to 60 percent on taxable income in excess of $89,700. The exchange rate on December 31, 1980 was $1 U.S. to 4.515 francs.

2/ Mortgage interest may be deducted in computing taxable income, up to $1,995 for a family of four. A deduction for life insurance premiums is allowed. The deduction is 100 percent of the first $220, and 50 percent of the excess, with a premium ceiling of $1,100. It is assumed that the $20,000, $50,000, and $100,000 income level taxpayers each pay $500 of life insurance premiums. Real estate taxes, general interest, and medical expenses are not deductible.

3/ Three deductions are allowed in computing adjusted gross income from employment. First, Social Security contributions may be deducted. From the balance, a deduction for professional expenses is allowed. This amount is either actual expenses, 10 percent of wages, or $400; the maximum deduction is $8,860. An employee's allowance may be deducted from the balance. This amount is 20 percent of the first $79,740 of remaining employment income.

4/ An employee's Social Security contributions for 1979 consist of:

Pension: 4.7 percent of the first $11,900 of wages;
Medical benefits: 1 percent of the first $11,900 of wages, plus 3.5 percent of total wages;
Unemployment insurance: .84 percent of the first $47,600 of wages.

5/ Interest on up to $10,000 of deposits in the National Savings Institution or a municipal savings association is exempt from tax. These savings pay about 7.5 percent interest; it is therefore assumed that all taxpayers receive $750 of exempt interest.

(Continued)

In lieu of including interest from savings institutions in gross income, the taxpayer may elect to have a final tax of 38 percent withheld at the source. It is assumed that the taxpayer elects this final tax for all interest which would otherwise be taxed at a higher rate if included in gross income. If ordinary taxation were elected in lieu of final withholding, the $50,000 income level taxpayer would pay $12,450 in taxes, 24.8 percent of gross income, at a marginal rate of 40 percent. The $100,000 income level taxpayer would pay $37,645 in taxes, 37.6 percent of gross income, at a marginal rate of 60 percent.

The rules for taxation of interest vary, depending on the source of the interest. Interest on bonds, for example, is entitled to an exclusion of up to $665. In lieu of including bond interest in gross income, the taxpayer may elect a final withholding tax of 25 percent, without the $665 exclusion.

France also exempts from taxation the interest on a housing savings account. Quarterly deposits of at least $100 must be made for a minimum of four years, in addition to a minimum deposit of from $100 to $10,000. When the principal is withdrawn, interest of 9 percent is paid, half of it by the government. This amount is not taxed. It is assumed that none of the taxpayers receive any interest from such an account.

6/ In computing adjusted gross income from dividends, the taxpayer must increase the amount of dividends received by 50 percent (the gross-up) to account for the corporate tax paid by the distributing corporation. A refundable tax credit equal to the amount of the increase is allowed. In computing taxable income, a deduction of $665 of adjusted gross income from dividends is permitted, if total taxable income is not more than $39,870.

7/ Capital gains from the non-habitual sale of stock are taxable only if total sales proceeds for the year exceed $33,225. Gain is taxed at a flat rate of 15 percent. Because capital gains from stock have been taxable only since 1979, the taxpayer may use a substituted basis for stock acquired before 1979, equal to the stock's highest sale price in 1978. The amounts listed are 15 percent of the gain; no adjustment has been made for a substituted basis.

The Monory law permits a deduction of the amount of a taxpayer's annual net increase in investment in French stocks, up to $1,100 a year; a taxpayer with two children may deduct up to $1,330. Although it is assumed in this study that the proceeds of the sale of stock are reinvested, it is not assumed that any net increase in investment occurs; no tax benefit under the Monory law is included in the computations.

FRANCE

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	0	10.0	19.0	29.0	0	(-49.3)	15.0
$10,000	0	10.0	13.6	23.6	3.1	(-38.6)	15.0
$20,000	3.5	7.8	10.6	21.5	9.6	(-25.3)	15.0
$50,000	12.7	5.7	7.2	25.6	24.2	(-1.5)	15.0
$100,000	22.1	4.6	4.4	31.1	31.1	18.1	15.0

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	100	100	0	(-463)	150
$10,000	0	100	100	150	(-204)	150
$20,000	103	43	146	250	25	150
$50,000	278	35	313	380	250	150
$100,000	482	35	517	380	400	150

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	10.0	10.0	0	(-46.3)	15.0
$10,000	0	10.0	10.0	15.0	(-20.4)	15.0
$20,000	10.3	4.3	14.6	25.0	2.5	15.0
$50,000	27.8	3.5	31.3	38.0	25.0	15.0
$100,000	48.2	3.5	51.7	38.0	40.0	15.0

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FEDERAL REPUBLIC OF GERMANY

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest 5/	Dividends 6/	Long Term Capital Gains 7/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	0	775	528	1,303	0	(-2,457)	0
$10,000	521	1,550	765	2,836	861	(-3,425)	0
$20,000	1,939	3,020	1,202	6,161	2,508	(-5,443)	0
$50,000	11,534	3,493	2,111	17,138	12,545	(-1,560)	0
$100,000	36,098	3,493	2,536	42,127	37,206	12,379	0

1/ Tax rates are for income received in 1980, except for Social Security tax rates, which are for 1979. The income tax rates range from 22 percent on taxable income of between $4,300 and $18,360, to 56 percent on taxable income of more than $132,600. The exchange rate on December 31, 1980 was $1 U.S. to 1.96 Deutsche marks.

2/ The taxpayer must count as gross income the rental value of an owner-occupied home. The annual rental value is determined to be 1 percent of the home's assessed value, which is 140 percent of the home's fair market value. Mortgage interest on the home may be deducted to the extent of rental value. The owner-occupier may also deduct an amount for depreciation of the home. In the first eight years of ownership, the annual depreciation deduction amounts to 5 percent of the first $76,500 of cost; for later years, and for cost in excess of $76,500, the deduction is 2 percent. It is assumed that the $20,000 income level taxpayer owns and occupies a home with a cost and fair market value of $38,250; the $50,000 income level taxpayer, a $76,500 home; and, the $100,000 income level taxpayer, a $153,000 home. Each home has been owned for less than eight years.

Married taxpayers may take a standard deduction of $306 for insurance premiums; the deduction limit is higher for taxpayers with employment income. A standard deduction of $245 may also be taken for special expenses, whether or not actually incurred.

Medical expenses may be deducted only insofar as they exceed a certain percentage of taxable income. For a married couple with 2 children, the percentages are:

taxable income of no more than $12,240: 3 percent;
taxable income of between $12,240 and $25,500: 4 percent;
taxable income of between $25,500 and $51,000: 6 percent;
taxable income of more than $51,000: 7 percent.

Federal Republic of Germany

(Continued)

Real estate taxes and general interest are not deductible.

All taxpayers receive a tax-free monthly child subsidy; for a couple with two children the monthly amount is $87. This amount has not been included in computing effective tax rates.

3/ In computing adjusted gross income from employment, three exclusions apply. First, an exclusion of $288, for employment expenses. Second, an employment income allowance of $245. Third, an exclusion of $205 of wages received in the month preceding Christmas.

A taxpayer with employment income may take a larger deduction for insurance premiums, including Social Security contributions, than the standard deduction of $306. It is assumed that only Social Security contributions are deducted. The deduction ceiling is: 9 percent of income (but no more than $1070), plus $306 for each child, plus 9 percent of income (but no more than $536), plus $153 for each child.

4/ Social Security contributions for 1979 consist of:

Pension contributions: 9 percent of the first $24,500 of wages;
Medical insurance: 5 percent of the first $18,400 of wages;
Unemployment insurance: 1.5 percent of the first $24,500 of wages.

5/ The first $408 of adjusted gross income from interest and dividends are exempt from taxation.

Under the Capital Accumulation Act, an employee may have up to $320 a year withheld from wages and invested in savings, insurance, or stock in the employer's company. The employee will then receive, tax-free, a cash payment from the government equal to 30 percent of the amount withheld; the payment is increased to 40 percent if the employee has three or more children. An employee may have taxable income of no more than $12,250 to qualify; for a married employee with two children, the income limit is raised to $26,325.

Under the Savings Premium Law, the government will pay bonuses of 14 percent on certain savings deposits. The deposits may be up to $410 annually, and must be held at least six years.

These government bonuses have not been taken into account in computing tax rates.

6/ In computing adjusted gross income from dividends, the amount received must be increased by 36/64 to account for the corporation tax paid by the distributing corporation. The amount of the increase is allowed as a refundable tax credit. The first $408 of adjusted gross income from dividends and interest are exempt from taxation.

7/ Long-term capital gains from the sale of stock are exempt from taxation, unless sold by a substantial investor in the corporation issuing the shares.

FEDERAL REPUBLIC OF GERMANY

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	0	15.5	10.6	26.1	0	(-49.1)	0
$10,000	5.2	15.5	7.5	28.2	8.6	(-34.2)	0
$20,000	9.7	15.1	6.0	30.8	12.5	(-27.2)	0
$50,000	23.1	7.0	4.2	34.3	25.1	(- 3.1)	0
$100,000	36.1	3.5	2.5	42.1	37.2	12.4	0

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	155	155	0	(-353)	0
$10,000	194	155	349	218	(-195)	0
$20,000	218	105	323	229	(- 24)	0
$50,000	435	0	435	447	245	0
$100,000	538	0	538	540	311	0

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	15.5	15.5	0	(-35.3)	0
$10,000	19.4	15.5	34.9	21.8	(-19.5)	0
$20,000	21.8	10.5	32.3	22.9	(-2.4)	0
$50,000	43.5	0	43.5	44.7	24.5	0
$100,000	53.8	0	53.8	54.0	31.1	0

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ITALY

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest 5/	Dividends 6/	Long Term Capital Gains 7/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	52	373	702	1,127	1,000	(-1,092)	0
$10,000	853	745	1,004	2,602	2,000	(-1,222)	0
$20,000	2,735	1,490	1,596	5,821	4,000	(-1,084)	0
$50,000	12,357	3,725	2,794	18,876	10,000	4,553	0
$100,000	32,041	7,450	3,358	42,849	20,000	18,807	0

1/ Tax rates are for income received in 1980, except for Social Security tax rates, which are for 1979. The income tax rates range from 10 percent on the first $3,240 of taxable income, to 72 percent on taxable income in excess of $594,000. The exchange rate on December 31, 1980 was $1 U.S. to 928 Lire.

2/ Medical expenses are fully deductible. Mortgage interest is deductible, up to $4,320. General interest and real estate taxes are not deductible. Insurance premiums are deductible, up to $2,700; it is assumed that taxpayers at the $20,000, $50,000, and $100,000 income levels pay premiums of $500 a year. Social Security contributions are deductible in full.

A family of four, filing a single return, is allowed a tax credit of $205: $40 for the taxpayer, $115 for the spouse (if the spouse has less than $1,000 of income), and $50 for two children.

3/ Taxpayers with employment income are allowed a tax credit of up to $180.

4/ Social Security contributions consist of:

Pension contributions: 7.15 percent of wages,
Medical insurance: .3 percent of wages.

5/ Interest from savings is subject to a final withholding tax of 20 cent.

6/ Taxpayers receiving dividends must increase the amount received by 1/3, to account for the corporation tax paid by the distributing corporation. An amount equal to the increase is allowed as a refundable tax credit.

7/ Long-term capital gains are not taxed.

ITALY

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	1.0	7.45	14.0	2.5	20	(-21.8)	0
$10,000	8.5	7.45	10.0	26.0	20	(-12.2)	0
$20,000	13.7	7.45	8.0	29.2	20	(- 5.4)	0
$50,000	24.7	7.45	5.6	37.8	20	9.1	0
$100,000	32.0	7.45	3.4	42.9	20	18.8	0

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	52	74.5	126.5	200	(-96)	0
$10,000	209	74.5	283.5	200	(-36)	0
$20,000	287	74.5	361.5	200	121	0
$50,000	371	74.5	445.5	200	254	0
$100,000	427	74.5	501.5	200	335	0

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	5.2	7.45	12.7	20	(-9.6)	0
$10,000	20.9	7.45	28.4	20	(-3.6)	0
$20,000	28.7	7.45	36.2	20	12.1	0
$50,000	37.1	7.45	44.6	20	25.4	0
$100,000	42.7	7.45	50.2	20	33.5	0

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JAPAN

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest 5/	Dividends 6/	Long Term Capital Gains 7/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	0	455	211	666	0	0	0
$10,000	0	1,105	301	1,406	0	0	0
$20,000	670	2,015	506	3,191	229	0	0
$50,000	6,375	3,494	952	10,821	5,678	4,851	0
$100,000	25,035	5,769	1,129	31,933	23,594	25,656	0

1/ Tax rates are for income received in 1980, except for Social Security tax rates, which are for 1979. The income tax rates range from 10 percent on taxable income of less than $2,960 to 75 percent on taxable income of more than $394,400. The exchange rate on December 31, 1980 was $1 U.S. to 202.8 yen.

2/ All taxpayers are allowed a deduction for medical expenses, to the extent that they exceed the lesser of 5 percent of adjusted gross income or $250. Real estate taxes, mortgage interest, and general interest are not deductible. Japan allows a deduction for life insurance premiums paid; it is assumed that all but the $5,000 and $10,000 income level taxpayers deduct the maximum amount allowed of $250. A family of four, where one spouse does not receive taxable income, is given a personal exemption, deductible in computing taxable income, of $5,920.

3/ Taxpayers are allowed an exclusion from earned income in computing adjusted gross income. The exclusion ranges from 40 percent of the first $7,400 to 10 percent of earned income in excess of $29,600. There is no special maximum tax rate on earned income.

4/ All employees contribute 4.55 percent of wages for health insurance and unemployment insurance. The first $22,500 of wages is subject to a 4.55 percent contribution for employee pension insurance. A contribution of $17 a month is collected from employees for the national pension plan; low-income wage earners, including the $5,000 wage earner, are exempt from this levy.

5/ Interest from several sources of saving is exempt from taxation. An individual who is not employed may receive interest, tax-free, from up to $44,370 of deposits. It is assumed that each family member maintains these accounts, and that these accounts pay 7 percent interest. It is assumed that 50 percent of interest income, up to $12,500, is exempt from taxation.

(continued)

Japan

(Continued)

A taxpayer may elect to have a 35 percent final tax withheld on interest income from a time deposit in lieu of subjecting the interest to progressive rates. It is assumed that the taxpayer at the $100,000 income level elects this final withholding tax on all interest income that would otherwise be taxed at progressive rates greater than 35 percent. If this final tax was not elected, this taxpayer would pay a total tax of $26,373, 26.4 percent of gross income, at a marginal rate of 50 percent. There is no advantage to the $50,000 income level taxpayer in electing the final withholding tax.

6/ A tax credit is allowed when dividends are received from Japanese corporations. The credit is 10 percent of the dividend for a taxpayer with less than $49,300 taxable income. The credit is 5 percent of dividends constituting taxable income of more than $49,300, and 10 percent of the remainder. The amount of the dividend is not increased in computing adjusted gross income. The credit is not refundable.

A taxpayer may elect to have a final tax withheld on certain dividends paid by a Japanese corporation in lieu of subjecting the dividend income to progressive rates. This may only be elected when the dividend received from the corporation is less than $2,500 and the taxpayer owns less than 5 percent of the corporation's stock, in which case the final tax is 35 percent, or when the dividend received is less thant $500, in which case the final tax is 20 percent. Dividends for which this final withholding tax is elected are not eligible for the dividend tax credit. It is assumed here that the taxpayer does not elect to pay tax on dividends through this final withholding mechanism.

7/ Long-term capital gains from the sale of stock are exempt.

JAPAN

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	0	9.1	4.2	13.3	0	0	0
$10,000	0	11.0	3.0	14.0	0	0	0
$20,000	3.4	10.1	2.5	16.0	1.1	0	0
$50,000	12.7	7.0	1.9	21.6	11.4	9.7	0
$100,000	25.0	5.8	1.1	31.9	23.6	25.7	0

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	91	91	0	0	0
$10,000	0	91	91	0	0	0
$20,000	123	91	214	23	0	0
$50,000	300	46	346	276	58	0
$100,000	500	46	546	350	449	0

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	9.1	9.1	0	0	0
$10,000	0	9.1	9.1	0	0	0
$20,000	12.3	9.1	21.4	10.0	0	0
$50,000	30.0	4.6	34.6	27.6	5.8	0
$100,000	50.0	4.6	54.6	35.0	44.9	0

UNITED KINGDOM

Total Tax Burden 1/
(In U.S. Dollars)

Gross Income 2/	Wages				Interest 5/	Dividends 6/	Long Term Capital Gains 7/
	Income Tax 3/	Social Security Taxes 4/	Consumption Taxes	Total			
$5,000	0	261	824	1,085	0	(-1,538)	0
$10,000	1,466	461	1,177	3,104	0	(-1,364)	853
$20,000	4,170	732	1,911	6,813	1,166	331	3,857
$50,000	15,197	732	3,439	19,368	6,854	13,484	12,870
$100,000	42,357	732	4,112	47,201	19,133	44,075	27,891

1/ Tax rates are for income received in the 1980 year of assessment, except for the Social Security tax rates, which are for 1979. The income tax rates range from 30 percent on the first $26,890 of taxable income to 60 percent on taxable income in excess of $66,325. The exchange rate on December 31, 1980 was $1 U.S. to .419 British pounds.

2/ In computing taxable income, taxpayers may deduct mortgage interest on a private residence on the principal amount of a loan which does not exceed $59,750; it is assumed that all mortgage interest payments stipulated are fully deductible. Real estate taxes, general interest, and medical expenses are not deductible. A married couple may deduct personal allowances totalling $5,125.

3/ There is no special maximum tax rate on earned income. Social Security contributions are not deductible.

4/ An employee's Social Security contributions for 1979 amount to 6.5 percent on the first $2,425 of wages, and 4.0 percent on wages in excess of that, with a wage ceiling of $16,780. No contribution is assessed when total wages are less than $2,425.

5/ Interest from National Savings Certificates, and $170 of interest from a postal savings account, are exempt from taxation. It is therefore assumed that half of all interest received is exempt from taxation.

A 15 percent surtax is imposed on adjusted gross income from interest and dividends in excess of $13,150; deductible mortgage interest may be applied to reduce the amount subject to this surtax.

United Kingdom

(Continued)

6/ In computing adjusted gross income from dividends, the amount received must be increased by 3/7, to account for the corporation tax paid by the distributing corporation. The amount of the increase is allowed as a refundable tax credit. A surtax of 15 percent is imposed on adjusted gross income from dividends and interest in excess of $13,150; deductible mortgage interest payments may be applied to reduce the amount subject to this additional tax.

7/ Capital gains are subject to a separate 30 percent tax; the first $7,170 of capital gains are exempt.

UNITED KINGDOM

Total Tax Burden
(Percentage of Gross Income)

Gross Income	Wages				Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Consumption Taxes	Total			
$5,000	0	5.2	16.4	21.6	0	(-30.8)	0
$10,000	14.7	4.6	11.8	31.1	0	(-13.6)	8.5
$20,000	20.8	3.7	9.6	34.1	5.8	1.7	19.3
$50,000	30.3	1.5	6.9	38.7	13.7	27.0	25.7
$100,000	42.4	.7	4.1	47.2	[illegible]5.1	44.1	27.9

Tax Burden on Last $1,000 Received
(In U.S. Dollars)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	40	40	0	0	0
$10,000	300	40	340	0	174	300
$20,000	300	0	300	150	214	300
$50,000	500	0	500	225	571	300
$100,000	600	0	600	325	644	300

Marginal Tax Rate on Last $1,000 Received
(Percentage)

Gross Income	Wages			Interest	Dividends	Long Term Capital Gains
	Income Tax	Social Security Taxes	Total			
$5,000	0	4.0	4.0	0	(-0.1)	0
$10,000	30.0	4.0	34.0	0	17.4	30.0
$20,000	30.0	0	30.0	15.0	21.4	30.0
$50,000	50.0	0	50.0	22.5	57.1	30.0
$100,000	60.0	0	60.0	32.5	64.4	30.0

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Appendix II

METHODOLOGY USED IN COMPUTING CONSUMPTION TAX DATA

Several studies of the tax burden in the United States have estimated the level of consumption taxes by income class. Most of the studies use similar methodologies. The burden of consumption taxes is usually assumed to be borne by the consumers of the taxed goods and services. Thus, the total amount of sales and excise taxes is usually allocated across income classes according to consumption patterns for the taxed items which are derived from detailed surveys of consumer expenditures.

To develop estimates of consumption taxes by income level for foreign countries a similar approach should be employed. Unfortunately, detailed data on consumption patterns by income class in foreign countries are not readily available. Therefore, in lieu of this procedure estimates of consumption tax burdens by income class in the U.S. have been adjusted to provide data for the foreign countries. The basic U.S. consumption tax burden data are derived from the MERGE microunit data file maintained by the Brookings Institution. */ This data source has been used for several tax distribution studies in the U.S. **/ The data provide tax level estimates by income class for both Federal excise taxes and State and local sales

*/ The data are in an unpublished table provided in a letter from Joseph Minarik, Research Associate, Brookings Institution, dated April 12, 1978. The data required some adjustments in order to estimate consumption tax burdens at the stated income levels.

**/ See for example, Pechman, Joseph A. and Benjamin A. Okner, Who Bears the Tax Burden? The Brookings Institution, Washington, D.C., 1974.

and excise taxes. The U.S. consumption tax burden data were adjusted to be representative of levels in other countries based on aggregate tax data */ and national income accounting data **/ published by the Organization for Economic Cooperation and Development (OECD). All calculations were based on 1977 data. The adjustments were based on calculated aggregate levels of consumption taxes as a proportion of household income in the other countries relative to the U.S. Separate calculations were made for excise taxes on specific commodities or services (the distributional pattern based on U.S. Federal excise taxes) and general sales taxes (the distribution based on U.S. State and local sales and excise taxes). Only the taxes levied by the central government in each country were taken into account in the calculations.

It needs to be emphasized that the consumption tax data are not of the same character as the income tax data, since they are not derived from assumed characteristics of the taxpayers at each income level and an application of the foreign nations' tax laws. Nor can they be regarded as actual estimates of consumption tax burdens in the countries since they are not based on the consumption patterns for the goods and services specifically taxed in each country. Rather, the data are U.S. consumption tax estimates adjusted to suggest the different overall levels of consumption taxes in the various countries. Thus, the consumption tax data reflect neither actual rates of value-added tax in foreign countries, nor reduced or zero rates of value-added tax for particular items or transactions.

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*/ The tax data are taken from, Revenue Statistics of OECD Member Countries 1965-1979, Organization for Economic Cooperation and Development, Paris, 1980.

**/ The national income data are from, National Accounts of OECD Countries 1961-1978, Volume II, Detailed Tables, Paris, 1980.

Consumption Taxes

Total Tax Burden
(In U.S. Dollars)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	427	951	528	702	211	824	123
$10,000	611	1,361	765	1,004	301	1,177	176
$20,000	977	2,123	1,202	1,596	506	1,911	296
$50,000	1,724	3,620	2,111	2,794	952	3,439	556
$100,000	2,069	4,373	2,536	3,358	1,129	4,112	660

Total Tax Burden
(Percentage)

Gross Income	Canada	France	West Germany	Italy	Japan	United Kingdom	United States
$5,000	8.5	19.0	10.6	14.0	4.2	16.4	2.5
$10,000	6.1	13.6	7.5	10.0	3.0	11.8	1.8
$20,000	4.9	10.6	6.0	8.0	2.5	9.6	1.5
$50,000	3.4	7.2	4.2	5.6	1.9	6.9	1.1
$100,000	2.1	4.4	2.5	3.4	1.1	4.1	0.7

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Mr. GOUREVITCH. We made separate comparisons of the tax burden on wage income and investment income. In measuring total tax burdens on wage income, we included the national income tax, the employee's portion of social security taxes and our estimate of national consumption taxes.

We did not include any State or local taxes. Neither did we include any national wealth taxes, such as Germany's net worth tax.

This is what we found. If one looks at the total tax burden, that is income taxes, social security taxes and consumption taxes, the tax burdens of individuals in the United States are not particularly high in comparison to those of individuals at corresponding income levels in other industrial countries.

In general, in the United States, a greater proportion of the total individual tax burden goes to income taxes and smaller proportions to social security and consumption taxes than in other industrial countries.

Turning to investment income, we made separate comparisons of dividend income, interest income, and capital gains. For dividend income we found that U.S. taxes are higher than those of other countries at almost every income level.

Each of the other countries gives residents or share holders a tax credit with dividend distributions from domestic corporations.

We did not look into tax burdens of distributed corporate income at the corporate level. It should also be noted that, unlike the United States, some of these countries impose a withholding tax on dividends paid to resident shareholders.

Germany, for example, has a 25-percent dividend withholding tax; Japan a 20-percent tax.

On interest income, U.S. taxation is either at the median or near the high end of the distribution of the countries we looked at.

Most of these countries exempt specified amounts of interest from certain sources. For example, Japan exempts the interest on postal savings accounts with a principal of up to about $15,000. Japan also exempts the interest from certain other savings accounts up to specified amounts of principal.

France has a number of interest exemptions including an exemption for interest on a housing savings account which earns 9 percent interest if held for the required period of at least 4 years.

Germany has a $400 dividend and interest exclusion and, in addition, it offers cash subsidies for certain kinds of savings accounts including a housing savings account, though these cash subsidies are subject to an income cap of approximately $24,000 for a 2-person family.

For budgetary reasons, Germany is now in the process of dismantling some of these cash subsidies and of reducing others.

Turning to capital gains taxation, most long-term capital gains are exempt from tax in Germany, Japan, and Italy. Canada exempts from tax 50 percent of the gain; the United States, 60 percent.

In our seven-country sample, the United States stands at the median in the taxation of capital gains. The picture that emerges is that generally in other industrial countries, investment income is taxed less heavily than in the United States.

I would like to say one or two words about possible uses and misuses of this type of international tax comparison. We believe that caution needs to be exercised in using these tax comparisons to draw conclusions about different levels of savings and investment in various countries.

We do know that some of these countries subsidize savings through various tax incentives. We also know that some of these countries have high savings rates compared to the U.S. savings rate. But, we do not know the degree of casual connection between tax incentives and the savings rate.

It is entirely possible that tax incentives raised the levels of savings in France, or Germany, or Japan, but we have not studied the question nor have we seen studies on the question by others.

One issue that would have to be addressed is the extent to which some of these incentives may have produced simply a shift in savings from one savings medium to another rather than a net increase.

In France, for example, when the French Government recently enacted the monory Law to stimulate investment in the stock market, the Government stated explicitly that its purpose was not to increase the savings rate in France but rather to bring about a shift in savings from savings accounts into the stock market.

In fact, the French Government predicted that the law would not result in a net revenue loss because the revenue loss on the stock market subsidy was expected to be offset by a reduced revenue loss on subsidized savings.

Similarly, France and Canada in recent years enacted a capital gains tax which they did not have before. We don't know whether the enactment of these capital gains taxes resulted in a drop in the savings rate in either of those countries.

Another reason for caution in interpreting these tax comparisons is that comparing individual tax rates and exemptions by themselves gives an incomplete picture of a government's tax policy for savings.

For example, we would also have to look at the taxation of corporate income at the corporate level and whether there is withholding on dividends.

Another subject that would need to be explored is the deductibility or nondeductibility for tax purposes of consumer interest and mortgage interest. Interest on consumer debt is nondeductible in all the countries surveyed except the United States. Mortgage interest is not deductible at all in Canada and Japan. Its deductibility is subject to limits in each of the other countries.

Such restrictions on deductibility of mortgage and consumer interest may play a role in determining national savings rates.

Thank you, Mr. Chairman.

Senator PACKWOOD. Mr. Gourevitch, I have only a few questions. I think your report speaks for itself, but I want to emphasize the conclusions for the record. I compliment you for not drawing conclusions beyond the facts.

Your report has not said that if we increase savings incentives, savings will increase. You are saying, it may or it may not, or there may not be any correlation. We have no evidence one way or the other. But, your studies conclude this and tell me if I am right or if I am wrong.

One, with the exception of Japan, the total tax burden in the United States is significantly lower than the tax burden in all of our major European competitors.

Mr. GOUREVITCH. I think that one can get that figure out of OECD data. I am not sure that our study really comes to that conclusion, but you can get that figure out of OECD data that as a percentage of gross domestic product, U.S. total tax revenues are lowest, except for Japan.

Senator PACKWOOD. Second, you conclude that all types of taxes taken together that you have studied, the U.S. consumption very lightly, comparatively speaking and taxes capital and investment and income relatively highly.

Now, let me ask you this: If we were to adopt the Kemp-Roth bill, would it significantly change the incidence of that taxation?

Mr. GOUREVITCH. We did look at this in a preliminary way and we found that in terms of the rankings in our report Kemp-Roth would lower the ranking of the United States with respect to the taxation of wage income and the taxation of interest income.

Senator PACKWOOD. But, I understand any tax reduction will lower that. But, when you are done, shouldn't you have a 10-10-10 and if you were to do another study, absent any changes in European countries, would it not still show that we tax consumption relatively lightly in comparison to them and capital and investment higher?

Now, let me ask you a last question. Assuming that tax incentives work and I know your study didn't conclude one way or the other, but, assuming that they work, would there be a better way to encourage savings and investment capital formation—a better method of tax incentives than the Kemp-Roth 10-10-10?

Mr. GOUREVITCH. I am in the fortunate position of being a lawyer and not an economist, and I think you would be better served if you asked an economist to answer that question.

Senator PACKWOOD. I think Dr. Freund will touch on it and I will ask him when we get to his testimony.

Steve?

Senator SYMMS. Just one question, Mr. Chairman and that is: Do you think that the United States would be better off if we reappraised our entire tax policy and went to a tax on consumption instead of the taxes on income and capital that we now have? I don't mean in addition to, but I mean instead of.

Mr. GOUREVITCH. I think that is a very complicated question. I think that to some extent ours is already a mixed tax system. We already have tax incentives that favor savings. We have deductions for qualified pension plans and that is a form of consumption-based taxation.

But, if you ask me whether we should shift over to a system, total tax system, based on consumption, I think that is really a very complicated question and I am not sure what the answer should be.

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

Senator PACKWOOD. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman.

I think that throughout our hearings we might not have been clear on what we mean by savings. For example, in our hearings we have frequently confused economic savings with financial savings. When we talk about savings in the committee we have frequently talked about whether we need to provide incentives so that we get more into this kind of bank or into that kind of bank.

Economic savings, as I understand it and maybe this is a question for Professor Freund too, is that in economic terms savings equals investment. What the committee deals with so frequently is really only financial savings. That means instead of buying corporate stock or a money market certificate you might put money in a savings bank or in some other kind of financial instrument. While this means that you have financial savings, you don't have economic savings in the sense that there is a net increase in personal savings and hence in investment capital. My question to you is—and this really follows onto a point that Senator Packwood made yesterday, I think maybe as a result of your study. In this country, we have financed the traditional kind of investment in plant and equipment out of equity investment, namely corporate stock.

With the incidence of increased capital gains taxes and the disparity between earned and unearned income, you had a flow away from that kind of investment often into highly speculative assets. The question arises, if we really wanted to get more investment to increase productivity wouldn't it be better to stimulate our traditional way of financing that kind of investment instead of trying to alter the habit of American consumers who have historically saved no more than 5 to 7 percent for a great many by forcing them to become 20-percent Japanese savers?

If that is so, wouldn't the kind of tax policy we should follow be along the lines of simply trying to reduce capital gains taxes and other taxes on investment income?

I think that was Senator Packwood's thesis yesterday. Would you agree with that based on your comparative analysis?

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Mr. GOUREVITCH. I don't think really that the comparisons that I have made would give me a complete enough picture of how investment is generated in these countries.

For example, it would be entirely possible to stimulate investment by doing so directly at the corporate level. You reduce the corporate rate or, as you are proposing to do, you can liberalize depreciation allowances and increase the investment tax credit. So, really to get a complete picture one would also have to look at tax policies at the corporate level.

Senator BRADLEY. Well, from the standpoint of economic efficiency, if you eliminate the equity question, but from the standpoint of economic efficiency savings is in part what you put in the bank. It is also a retained earning.

Is it your view that in other countries, they make a judgment as to which of those types of savings can be used most efficiently? I mean, are retained earnings used most efficiently if our goal is to increase productivity or are savings through various savings incentives a more effective way to increase productivity?

It would seem to me that the incentives route really is only a kind of middleman if what we want to do is actually increase producivity. The reason is that you have to depend on the financial institution that receives the additional savings using them wisely so that you increase productivity as opposed to the equity of a corporation which is in the business of making productive investment.

Mr. GOUREVITCH. I'm sorry, but I am not sure I fully understand your question.

Senator BRADLEY. All right. Maybe we will wait for Professor Freund.

Senator PACKWOOD. Senator Long.

Senator LONG. No questions.

Senator PACKWOOD. Dr. Freund.

STATEMENT OF DR. WILLIAM E. FREUND, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, NEW YORK STOCK EXCHANGE

Dr. FREUND. Thank you for this opportunity to discuss the recent New York Stock Exchange study, "U.S. Economic Performance in a Global Perspective." With your permission I would like to submit for the record a longer summary and the study itself.

Senator PACKWOOD. They will both be placed in the record.

Dr. FREUND. Our study identifies three elements of economic performance—real economic growth, inflation, and unemployment.

We analyzed these three factors for eight countries—Canada, France, Italy, Japan, Sweden, the United Kingdom, the United States, and West Germany.

A newly developed Economic Performance Index combines these factors into one overall measure of performance. Since 1973, our overall economic performance managed to beat out only the United Kingdom and Italy. Not surprisingly, Japan ranked first, West Germany second.

As part of our detailed examination of these three factors in the index, we found that economic growth rates in each country declined sharply in the 1970's compared with the 1960's. We also

found that since 1973, Canada, France, and Japan each had higher growth rates than we did.

We asked Prof. John Kendrick, an expert on growth economics, to analyze the reasons for differences in growth rates among the eight countries. The primary reason for our lackluster real economic growth rate was our abysmally low rate of capital investment.

In fact, the United States had the lowest rate of business investment of any of the countries studied. Japan's rate was double our own. Professor Kendrick reached one startling conclusion. If the United States had invested in modern plants and equipment at the same rate as Japan, the United States would have had substantially the same growth rates.

We hear so much these days about the work ethic in Japan, their management-labor policies and their government business relations. All of these undoubtedly play a role in Japan's superior performance. But, business capital investment has been the dominant, single most important factor.

Next, we explored the effect of tax burdens on savings and investment in the eight countries. We know that investment is crucial for economic growth and that funds for capital investment come out of savings.

Since the United States has the lowest rate of capital investment, we wondered if our savings rate could help account for it.

The United States does have the lowest rate of personal savings of any of the countries studied. Although many factors affect personal savings, tax policies certainly play a role.

To gain new insights into the effect of tax rates on savings, we commissioned Price Waterhouse & Co. to calculate actual income taxes imposed on two hypothetical families in the eight countries.

I might add, Mr. Chairman, we did not unstack investment income as did the Congressional Record Service. Ours was stacked, that is, we assumed investment income was taxed on top of salary income.

We took an individual with a salary of $20,000 and some income from interest, dividends, and capital gains. We took another with a salary of $50,000 and proportionately more investment income. Both were assumed to have a wife, two children, normal medical expenses, interest on a mortgage and so on.

Price Waterhouse calculated the total tax due and the marginal tax on the investment income under the tax laws of each country.

The United States imposes the second highest tax on investment income. For the $50,000 salary case, the marginal tax on investment income in the United States is 33.5 percent compared with less than 12 percent in Germany and just over 14 percent in Japan.

In general, we found that low tax rates on investment incomes are associated with high rates of personal savings and vice-versa. In fact, the four countries with the highest savings rate had tax burdens on investment income of 14 percent or less; the four with the lowest savings rates had tax burdens of 30 percent or more.

These results suggest that the relatively poor savings and investment showing of the United States is related to its tax policies and that lowering the tax burden on investment income is important for encouraging savings, investment, and economic growth.

May I have another minute?

Senator PACKWOOD. Go ahead and finish your statement.

Dr. FREUND. I am not here today, Mr. Chairman, to support any specific tax legislation but to present the findings of our study. Nevertheless, we asked Price Waterhouse to calculate the effect of the President's proposed across-the-board tax cut on the burden of taxes placed on investment income in the United States.

Their calculations show that the tax burden would decline from its present 33.5 percent to 30.5 percent after the first 10-percent tax cut and to 25.5 percent after the third consecutive 10-percent tax cut.

That, of course, is progress in the right direction but it would leave U.S. tax rates on investment income at more than twice the German and almost twice the Japanese rate.

Our study also carries an important negative conclusion. A high rate of savings, though necessary for good economic performance, alone is insufficient.

Though Italy had a high rate of savings its overall economic performance was poor because Italy incurred a huge national budget deficit, which diverted savings from the private investment sector to government bonds.

This suggests that strong economic performance is inconsistent with large central government deficits, lest these deficits sop up private savings, contribute to high interest rates and inhibit private sector capital investment.

Mr. Chairman, these are, very briefly, the highlights of our study. Although our tax calculations were based on different assumptions then the study of the Congressional Research Service, the conclusions are roughly similar.

Our full report analyzes in much greater detail, factors affecting productivity, growth, inflation, employment and unemployment.

I would be happy to answer questions you may have.

Senator PACKWOOD. I want you to reaffirm that last statement. You basically conclude, as does the Library of Congress study, that we tax consumption relatively lightly and we tax investment and savings relatively high.

Dr. FREUND. That is correct.

Senator PACKWOOD. If we were to pass the administration's program, while it is a step in the right direction, it would not significantly alter that conclusion. That is that we would still tax consumption relatively lightly and investment and savings relatively high.

Dr. FREUND. I can quantify that by saying that in the example I cited of the $50,000 hypothetical individual, the present tax on investment income in the United States is 33.5 percent—the second highest rate right after Sweden. After a 1 year, 10-percent tax reduction, we would be the third highest at 30.6 percent and after 3 years of tax reduction, we would be at 25.4 percent which would still leave us as the fourth highest.

Senator PACKWOOD. Let me ask you the question I posed to Mr. Gourevitch.

If you were going to design a tax system which would tilt heavily toward lightening the burden on savings and investment and capital formation, would it be the 10-10-10 approach or would you tilt the tax reduction in some other form?

Dr. FREUND. Mr. Chairman, our study does not provide data on the best or optimum way to encourage savings and investment.

Obviously, as we just discussed, a broad tax cut works in the right direction even though it leaves our tax burden on investment income at a relatively high level.

Speaking not for the New York Stock Exchange, but as an economist with some experience, I would think that some measure to target taxes on savings and investment either now or as a supplement later, would be desirable. But, I do not know the best way to accomplish that.

Senator PACKWOOD. Next question. All during the 1950's and 1960; the United States—you can take any 5-year period you want—had a lower rate of savings then they had from 1971 to 1975. That was the highest 5 year period in our average.

If that is the case, why did we have such a boom, comparatively speaking in the 1950's and 1960's and a downturn, as you indicate, starting in 1973 and it was 1973, 1974, and 1975 that were the 3 highest years in our saving's history save for World War II?

Dr. FREUND. Actually, Mr. Chairman, our record in the United States wasn't that good relative to other countries in the period 1960 to 1973. In our economic study, and I am referring to page 11, where we show an overall aggregate economic performance index, we find that the United States ranked second from the bottom.

Senator PACKWOOD. Second from what?

Dr. FREUND. From the bottom of the list of countries in terms of economic performance and we were just ahead of the United Kingdom.

It is true that in that early period we had a rapid rate of economic growth and we had a relatively low rate of inflation. We also had a low rate of unemployment.

Those are the three elements of our performance index. But, so did other countries have a very rapid rate of economic growth and so did other countries have a low rate of unemployment and a low rate of inflation.

The level of performance was higher, but compared to other countries we did not perform very well even back then.

Senator PACKWOOD. Then, is your sole conclusion that we went—let's compare the United States to the United States—that we went downward in the 1970's even though we reached our highest rate of savings solely because of the increasing deficits?

If savings is the key to investment and our savings kept getting higher and higher as we reached into the mid-1970's, why did our productivity or increase start to turn down? Why did our capital formation go down when our savings were going up?

Dr. FREUND. Because the increase in savings was not matched by an increase in private investment.

Senator PACKWOOD. Why?

Dr. FREUND. Well, I would have to say that we were running substantial Federal deficits, that these served to sop up private savings. Indeed, we have a negative lesson that we learned in our study of relative economic performance and that is the case of Italy.

Italy has the highest rate of savings of the eight countries we studied. They also have one of the worst performing economies of

all the countries we studied. There are undoubtedly a number of reasons, but the dominant one is that Italy runs the largest deficit relative to its GNP of all the countries we studied.

What happens is that private savings are absorbed to finance the government deficit and therefore is unavailable for private investment which is, of course, the key to technological progress and productivity growth.

Senator PACKWOOD. Thank you. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. Would you take a crack at answering the question as to whether in this country we have historically invested directly through equity versus savings that were then channeled into investment through a financial intermediary. In your judgment has the increase in capital gains taxes and other forms of taxes on unearned income discouraged equity investment and hence lowered productivity?

Dr. FREUND. Senator Bradley, as one of your constituents from Millington, N.J., I am delighted to have an opportunity to respond to that question.

Senator BRADLEY. As one of your frequent readers in the Newark Star Ledger, I am pleased that you will.

Dr. FREUND. Senator, I think you are absolutely on target, if I may put it that way, that we need more risk-taking and more entrepreneurship in this country. I think your question refers to the fact that much of the savings flow has been going into tax exempts, into commodities like gold and silver and jewelry, and into real estate rather than into physical capital which incorporates new technology in the production process.

A reduction in the marginal rate on investment income can do a great deal to promote the kind of economic strategy which promotes savings and productive investment.

Senator BRADLEY. But, the question is, here we are weighing two courses. One is to provide very generous savings incentives such as increasing IRA's to $5,000 for example. And the other would be to reduce the tax on unearned income and thus to reduce the capital gains tax significantly.

If you were going to chose between those two courses, which do you think would get the greatest bang for the buck in the sense of higher economic growth?

Dr. FREUND. I can, perhaps, cast a little bit of light on that because prior to coming here we asked Price Waterhouse to extend the study that they did for us earlier. As I mentioned, Price Waterhouse calculated the impact of the 10-10-10 proposal. We also asked them if they would calculate, for example, the effects of a 75-percent capital gain exclusion, a number I happened to pick out of the air.

At the moment, for the hypothetical $50,000 individual I cited earlier, capital gains are at a marginal rate of 26.8 percent. A 75-percent capital gain exclusion would reduce that to 19.1 percent.

If you had both a 75-percent capital gain exclusion and a 50-percent maximum tax on income, the marginal tax on capital gains would decline from 26.8 cents down to 18.2 cents. Those are very substantial reductions.

Senator BRADLEY. How do you weigh increasing the deductions for IRA's and LERA's, or increasing tax exemptions for certain

savings instruments against lowering tax rates, keeping in mind that the goal is to get the economy growing again? Keeping in mind also that much of our investment in the past has come from corporations that obtain capital through equity financing as opposed to borrowing on the financial markets.

Dr. FREUND. I do not really know the answer to that. I am sorry if I disappoint you, but the question is which, as you put it earlier, is economically the more efficient means? I have not studied that and therefore, I do not know.

Senator BRADLEY. OK. You made a point though about what happens when people invest in nonequity investments. In the analysis that you have provided to the committee and in your comments comparing our economy to the economies of other countries you referred to the way we subsidise housing and consumer interest. In this country we subsidize mortgage interest by roughly $25 billion. So there is at present a $25 billion subsidy to homeownership. Deductibility of property tax is another $10 billion, so we have a very sizable subsidy for investing in owner occupied housing.

If you take a long-term view and you want to increase productivity then one of the things you have to begin to weigh is whether reducing marginal tax rates would lead to greater productive investment then the present system of tax expenditures that direct investment so heavily toward housing. That is a judgment that you have make. Would you not agree?

Dr. FREUND. Yes, I would certainly agree and that in the period, especially of the 1960's and early 1970's, one of our national objectives seemed to be to encourage homeownership. A laudable objective it was.

But, in some ways that was to the detriment of capital equipment. I read recently where an economic commentator, a colleague, said in the United States we seem to have the most magnificant houses and the worst factories. Whereas in Japan they have the most magnificant factories and the worst housing.

That has certainly been an element of the allocation of our savings in this country.

Senator BRADLEY. May I ask another question?

What would be your reaction to a proposal to freeze the rate at which an individual is taxed on his last $1,000. In other words, you have a worker who has been at the 20- or 25-percent bracket. His salary is set and he has to decide whether he goes out into the underground economy or whether he works overtime.

Now, if he works overtime, he is pushed into a higher tax bracket. What if we said that he would not be pushed into a higher-tax bracket, but the tax bracket he was in on the last $1,000 of his salaried income would be tax bracket he would stay in as his income increased from overtime?

Dr. FREUND. Certainly lower-marginal taxes would do something to enhance the supply of labor.

Senator BRADLEY. But, it is not across-the-board. It is a lower-marginal tax rate specifically for increased work—overtime.

Dr. FREUND. I haven't thought about that, but it is something I would like to consider.

Senator BRADLEY. Thank you.

Senator PACKWOOD. Senator Long.

Senator LONG. No questions.

Senator PACKWOOD. I have no further questions. Bill, do you have any more?

Senator BRADLEY. Well, I know it is a long day, Mr. Chairman. I have a few more, but since Mr. Freund comes from Millington, N.J., I will see him up there.

Senator PACKWOOD. Gentlemen, thank you very, very much.

Mr. GOUREVITCH. Thank you.

Dr. FREUND. Thank you.

[Statements follow:]

PREPARED STATEMENT OF HARRY G. GOUREVITCH, SENIOR SPECIALIST IN TAXATION AND FISCAL POLICY

Mr. Chairman and members of the committee, I welcome this opportunity to summarize the study we prepared at Senator Packwood's request comparing the tax burdens on households at different income levels in the United States and six other industrial countries—Canada, France, West Germany, Italy, Japan and the United Kingdom.

Separate comparisons were made of the tax burdens on wage income and investment income.

In measuring total tax burdens on wage income, we included a household's liability for the country's Federal or national income tax, the employee's portion of national social security taxes and our estimates of national consumption taxes. We did not include any state or local taxes. Neither did we include any national wealth taxes, such as Germany's net worth tax.

This is what we found. If one looks at the total tax burdens—that is, income taxes, social security taxes and consumption taxes—the tax burdens of individuals in the United States are not particularly high in comparison to those of individuals at corresponding income levels in other industrial countries. In general, in the United States, a greater proportion of the total individual tax burden goes to income taxes and smaller proportions to social security and consumption taxes than in other industrial countries.

Turning now to investment income, we made separate comparisons of dividend income, interest income and capital gains. We assumed that each type of investment income was taxed as a separate "stack" starting at the lowest tax rate rather than taking combinations of different types of investment income and "stacking" them on top of wage income. For dividend income, we found that U.S. taxes are higher than those of the other countries at almost every income level. Each of the other countries gives resident shareholders a tax credit with dividend distributions from domestic corporations. We did not look into tax burdens of distributed corporate income at the corporate level. It should also be noted that, unlike the United States, some of these countries impose a withholding tax on dividends paid to resident shareholders. For example, Germany has a dividend withholding tax of 25 percent, Japan of 20 percent.

On interest income, U.S. taxation is either at the median or nearer the high end of the distribution. Most of these countries exempt specified amounts of interest from certain sources. For example, Japan exempts the interest on postal savings accounts with a principal of up to about $15,000. Japan also exempts the interest from certain other savings accounts up to specified amounts of principal. France has a number of interest exemptions, including an exemption for interest on a housing savings account which earns 9 percent interest if held for the required period of at least four years. Germany has a $400 dividend and interest exclusion and, in addition, it offers cash subsidies for certain kinds of savings accounts, including a housing savings account, though these cash subsidies are subject to an income cap of about $24,000 for a two-person family. For budgetary reasons, Germany recently introduced legislation to abolish some of these cash subsidies and to reduce others.

Turning to the taxation of capital gains, most long-term gains are exempt from tax in Germany, Japan and Italy. Canada exempts from tax 50 percent of the gains, compared to 60 percent in the United States. In our seven-country sample, the United States stands at the median in its taxation of capital gains.

The picture that emerges is that generally in other industrial countries investment income is taxed less heavily than in the United States.

I would like to say a few words about possible uses and misuses of these international tax comparisons. We believe that caution needs to be exercised in using these

tax comparisons to draw conclusions about different levels of savings and investment in various countries. We do know that some of these countries subsidize savings through various tax incentives and we also know that some of these same countries have relatively high savings rates compared to the U.S. savings rate. What we do not know is the degree of causal connection betweeen the tax incentives and the savings rate. It is entirely possible that tax incentives have raised the savings rate in Germany or France or Japan, but we have not studied the question nor have we seen studies on the question by others. One issue that would need to be addressed is the extent to which some of these tax incentives may have produced a shift in savings from one savings medium to another rather than a net increase. In France, for example, when the government enacted the Monory law in 1978 to stimulate investment in the French stock market, it stated explicitly that its purpose was not to increase the savings rate in France but rather to bring about a shift in savings from savings accounts into the stock market. In fact, the government predicted that the law would not result in a net revenue loss because the revenue loss on the stock market subsidy was expected to be offset by a reduced revenue loss on subsidized savings accounts.

Similarly, we don't know whether the enactment in recent years of a capital gains tax in France and in Canada resulted in a drop in the savings rate in either of those countries.

Another reason for caution in interpreting these tax comparisons is that individual tax rates and exemptions by themselves give an incomplete picture of a government's tax policy towards savings. For example, when comparing tax burdens on dividends one should also look at the taxation of such income at the corporate level and whether or not there is withholding on dividends. Another subject that needs to be explored is the deductibility or nondeductibility for tax purposes of consumer and mortgage interest. Interest on consumer debt is nondeductible in all the countries surveyed, except the United States. Mortgage interest is not deductible at all in Japan and Canada, and its deductibility is subject to limits in each of the other countries. Such restrictions on the deductibility of mortgage and/or consumer interest may also play a role in determining national savings rates.

Prepared Statement of Dr. William C. Freund, Chief Economist and Senior Vice President, New York Stock Exchange

I appreciate this opportunity to comment on the direction of federal tax policy. My testimony does not endorse or reject any specific legislative tax initiative, but instead presents new evidence on the special significance of reducing taxes on investment income. The results of a major new study by the New York Stock Exchange entitled "U.S. Economic Performance in a Global Perspective" provides new data indicating that: (1) Higher rates of capital investment will spur economic growth and help reduce inflation, and (2) tax incentives play an important role in determining saving, the source of investment.[1]

It is the results of this study I wish to share with you today. The study focuses on eight major industrialized countries: Canada, France, Italy, Japan, Sweden, United Kingdom, United States, and West Germany. It assesses how well each of the country's economies have performed in terms of three factors: Real economic growth and productivity, inflation, and employment and unemployment. As part of our analysis of economic growth and productivity, we looked at tax rates on investment income to see how they affected growth rates in the various countries. That is the part of the study I wish to focus on in particular.

But before getting to the tax section of our study, let me briefly place that analysis in the broader perspective of the study as a whole.

Overall Economic Performance—The Economic Performance Index

Since our analysis deals with eight countries and three economic variables, it could lead to a bewildering array of economic statistics. In order to bring the statistics down to a manageable size, my colleagues at the Exchange and I developed a new overall measure of economic performance, the Economic Performance Index (EPI). The index places the rate of economic growth in the numerator and divides it by the sum of the inflation rate and the unemployment rate. You may recognize the denominator as the late Arthur Okun's "Discomfort Index" which adds inflation to unemployment to measure economic "discomfort." Economic Performance Index equals real economic growth rate divided by inflation rate + unemployment rate. The way the index works is that, all else equal, the higher the rate of economic

[1] A copy of the study is available on request to Dr. William C. Freund, Office of Economic Research, New York Stock Exchange, 11 Wall Street, New York, N.Y.

growth, the higher the index; the higher the rate of inflation or unemployment, the lower the index. The larger the index overall, the better a country's economic performance.

TABLE 1.—*Economic performance index: 1960-73 and 1974-80*

1974-80:	
Japan	37.8
Germany	29.0
France	18.0
Canada	16.5
Sweden	15.3
United States	15.2
Italy	13.4
United Kingdom	2.2
1960-73:	
Japan	145.9
Germany	123.9
France	85.5
Italy	67.7
Canada	64.2
Sweden	55.6
United States	50.4
United Kingdom	43.1

Source: NYSE

We calculated the index for two periods—1960-1973 and 1974-1980. As you can see in Table 1, the U.S. ranked near the bottom in both time periods. Also note that the EPI declined in each country, comparing the former time period with the latter. In fact, such has been the decline in economic performance overall that Japan's top ranking performance in the 1974-1980 period would have placed it last in the earlier period.

What we did next was to examine more closely the three factors that make up our index. Because this Committee's primary concern today is tax policy, I will confine my testimony to that part of our study which analyzes the role of tax policy in saving, investment and economic growth. For the record I have also submitted our entire study which includes our findings with respect to inflation and unemployment.

ECONOMIC GROWTH

As part of our analysis of those factors which comprise our index, we looked at the performance of the eight countries in terms of economic growth. What we found was that Japan had the highest growth rate in both the 1960-1973 period and in the 1973-1979 period. And, as noted, growth rates in every country slowed since 1973 compared with the earlier period. Lastly, we found that three countries, Japan, Canada, and France, had faster rates of real economic growth than the U.S. in the 1973-1979 period—4.0 percent, 3.2 percent and 2.9 percent, respectively, compared with 2.7 percent in the U.S.

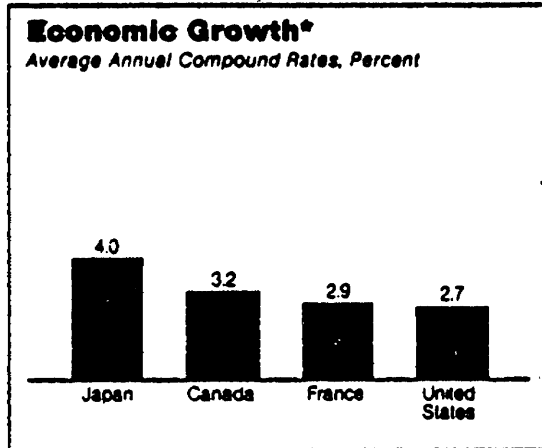
To determine why growth rates differed (1) among countries and (2) within countries over time, we asked Dr. John Kendrick, economics professor at George Washington University, and an acknowledged expert on the study of growth and productivity, to conduct a detailed analysis for us.

He found that economic growth in Japan, Canada, and France since 1973 exceeded the U.S. growth rate primarily because of higher rates of capital investment. In fact, the U.S. has the lowest rate of capital investment, that is, non-residential fixed investment as a percent of GNP, of any nation we studied (Chart 1).

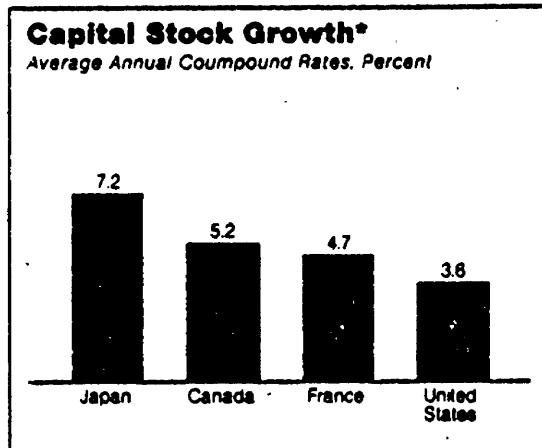
CHART 1

Reasons Why U.S. Economic Growth Lags Behind Other Countries

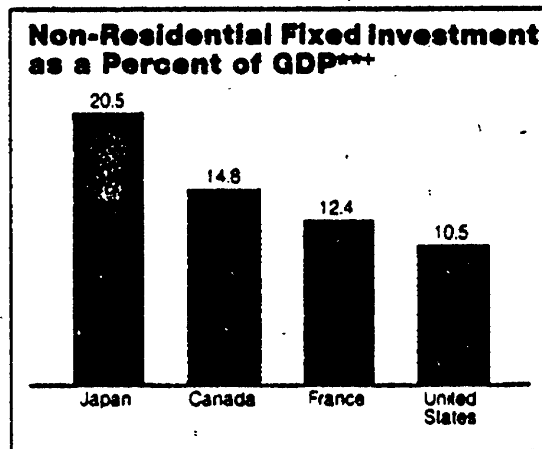
In the recent period, Japan, Canada and France have had higher rates of economic growth than the U.S....



primarliy because they have had higher rates of growth of capital.



They have had higher rates of growth of capital primarily because they have had higher rates of capital investment.



* 1973–79
\+ 1973–78
** Comparable figures for the other four countries are as follows: West Germany-13.3%. Sweden-13.2%. United Kingdom-12.7%. Italy-10 7%.

Sources: U.S. Department of Commerce, NYSE.

His analysis also leads to a rather startling conclusion: If the U.S. capital stock had grown at Japan's rate, the U.S. rate of economic growth would have been substantially the same as Japan's. I have termed this conclusion startling because it runs counter to the widely held view that management techniques, social factors, labor-management and government-business relations are the primary reasons for Japan's superior record in terms of economic growth.

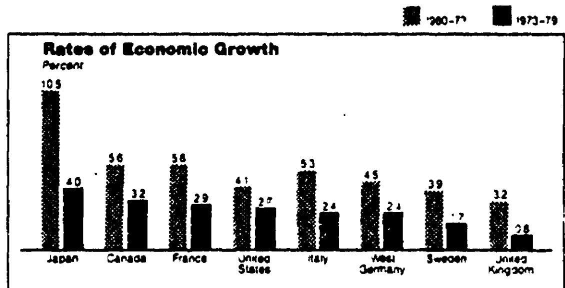
Dr. Kendrick's final conclusion is that within countries, most of the slowdown in economic growth since 1973 is due to slower growth in labor productivity (Chart 2), which reflects to a large degree slower growth in technological advances, and increased government regulations.

CHART 2

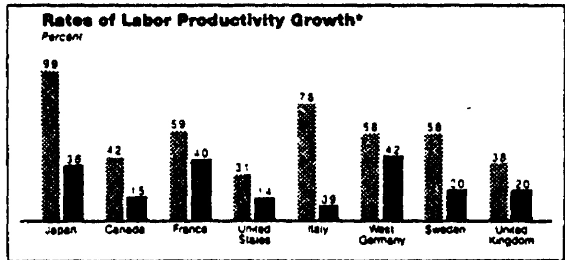
Reasons for the Slowdown in Economic Growth

1960-73 1973-79

For all eight countries: The slowdown in economic growth...



has been due primarily to the slowdown in growth of labor productivity.



INVESTMENT TAXES, SAVING AND ECONOMIC GROWTH

Next, we explored the effect of tax burdens on savings and investment in the eight countries. We know that investment is crucial for economic growth. We know that funds for capital investment come out of saving. We know that the U.S. has the lowest rate of capital investment. What we wondered is if the U.S. personal saving rate also compares unfavorably. The study found that, in fact, it does. The U.S. personal saving rate is lower than in any of the other countries covered in the study.

How does one account for the relatively poor performance of the U.S. in this vital area? There are no simple explanations, but surely public policies play a role. And chief among those policies is the method of taxation—how the tax burden influences the decision to save and invest.

Accordingly, our study looked at the relationship between taxes and saving in the eight countries. Our method of comparison is unique. We take an individual receiving different categories of income and determine how the tax collector would treat him in the U.S. and in the other seven countries. We commissioned Price Waterhouse and Company, the international accounting firm, to calculate the effective tax burden (after assumed exemptions and deductions) on salary and investment income of two hypothetical investors in each of the eight countries—one with a salary income of $50,000 and one with a base salary of $20,000.[1]

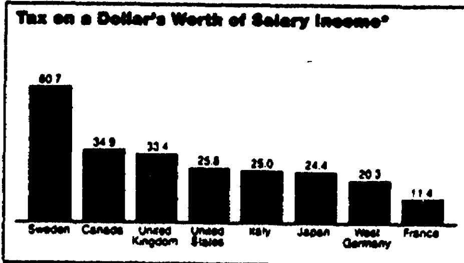
In the first set of bars in the upper left panel of Chart 3, we begin by assuming that our taxpayer has no investment income.

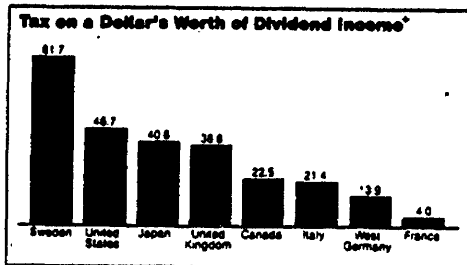
[1] A copy of the full Price Waterhouse analysis, "Tax Policy Incentives to Capital Formation," is available on request from Dr. William C. Freund, Office of Economic Research, New York Stock Exchange, 11 Wall Street, New York, New York 10005.

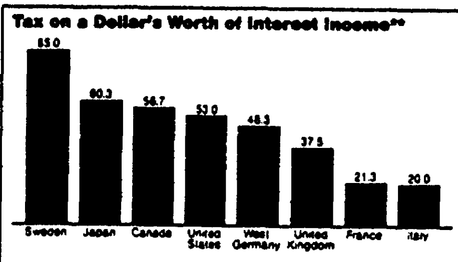
CHART 3

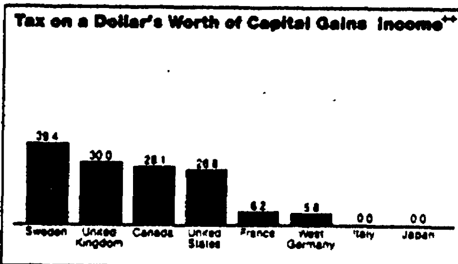
Comparative Tax Burdens on Individuals: Eight Countries

Cents









* Assumes individual receiving $50,000/year in salary. See text for further explanation.

\+ Assumes individual receiving $50,000/year in salary plus $10,000 in dividends. The tax rate on the dividend income is the tax rate over and above the tax imposed on the $50,000 in salary (the marginal rate). See text for further explanation.

** Assumes individual receiving $50,000/year in salary plus $10,000 in dividends and $5,000 in interest. The tax rate on the interest income is the tax rate over and above the tax imposed on the $60,000 in salary and dividend income (the marginal rate). See text for further explanation.

++ Assumes individual receiving $50,000/year in salary plus $15,000 in dividends and interest plus $34,000 in income from capital gains. The tax rate on capital gains income is the tax rate over and above the tax imposed on the $65,000 in salary, dividends, and interest income (the marginal rate). See text for further explanation.

Source: NYSE.

It shows that his $50,000 a year salary would be taxed most heavily in Sweden—60.7¢ on the dollar; the U.S. is somewhere in the middle at 26¢ on the dollar.

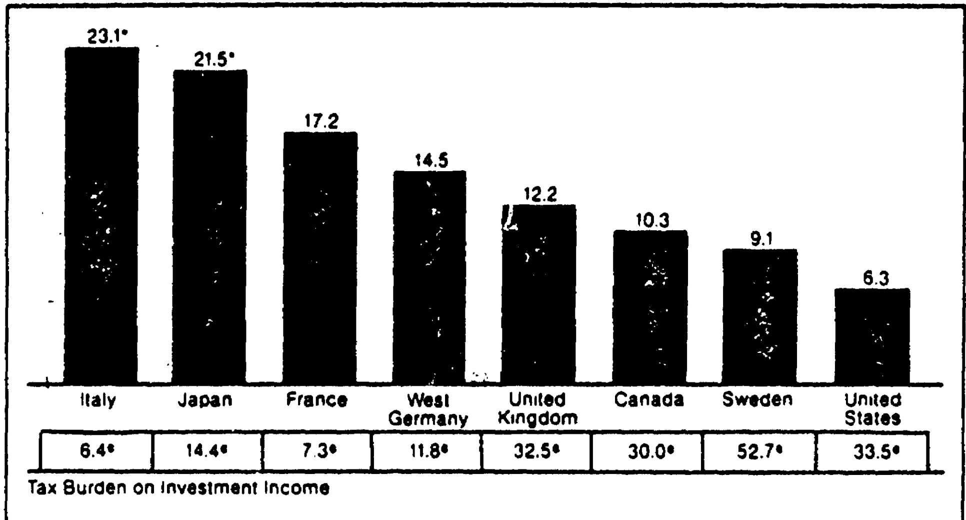
The upper right panel shows what our investor would pay on dividend income, assuming he has holdings of stocks on which he earns a yearly dividend income. Again, Sweden is the most punitive, the U.S. is second highest at 47¢ on the dollar. By the way, that 47¢ represents the marginal rate—that is, what he pays for the dollar of additional alone.

The lower left panel shows the marginal rate on interest income—this time our investor is assumed to have also accumulated holdings in bonds from which he receives interest income. As can be seen, the U.S. is near the top end at 53¢ on the dollar. Sweden is still out in front, taxing 85¢ out of each dollar.

The final panel makes one last assumption: our investor has sold a large portion of stock that he had accumulated over a period of years. The sale has netted him a capital gain on which he must pay a tax. We can see that the U.S. investor pays significantly more than his counterpart in France, West Germany, Italy and Japan—27¢ on the dollar compared with 6¢ or no tax at all.

In Chart 4 we combine the marginal rates on investment income into one overall rate, combining the three types of investment income—dividend, interest and capital gain—and compare this overall rate of tax with the savings rate in each of the eight countries. What we find is that the U.S. has the second highest overall tax burden on investment income. Further, in the four countries with the highest personal saving rate—Italy, Japan, France and West Germany—the $50,000 salaried investor faces the lowest effective tax burden on investment income—between 6¢ and 14¢ on the dollar. However, in Canada, Sweden, the United Kingdom and the United States—which have the lowest personal saving rate—he faces the highest effective tax burdens on investment income—between 30¢ and 53¢ on the dollar. This relationship also holds for the $20,000 salaried investor.

CHART 4



*Saving as a percentage of disposal personal income: 1975-1979 average
••Tax on a dollar's worth of investment income for individual receiving $99,000 in all; $50,000 in salary, $10,000 in dividends and $5,000 in interest, $34,000 in capital gains. See text for further explanation.

Source: For Sweden, OECD; all others, U.S. Dept. of Commerce.

These results suggest that the relatively poor saving and investment performance of the U.S. is related to its tax policies and that lowering the tax burden on investment income is important for encouraging saving, investment and economic growth.

These results strongly emphasize the importance of reducing taxes on U.S. investment income. Our study shows that we have a long way to go before the U.S. tax code treats investment income on a par with most other major industrialized countries.

PRESIDENT REAGAN'S TAX PROPOSAL

As an adjunct to its work on comparative tax rates for our study, we also asked Price Waterhouse and Company to calculate the effects of President Reagan's proposed cuts in individual income taxes. The purpose was to determine how the U.S. would rank among other countries in the taxation of investment income. Assuming adoption of the first stage of President Reagan's proposal, that is, a 10 percent cut in rates, we find that the hypothetical $50,000 investor in the U.S. would still pay the third highest overall rate—30.6¢ on the dollar (Table 2). Assuming the full 27 percent three-year reduction goes into effect by 1984, the U.S. shifts to fourth place out of eight, with a tax of 25.4¢ on the dollar. That would still leave the U.S. tax on investment income at more than twice that in West Germany and more than one and one-half times that in Japan.

TABLE 2.—*Tax on a dollar's worth of investment income* [1]

[Cents per dollar]

Sweden	52.7
United States	[2] 33.5
United Kingdon	32.5
Canada	30.0
Japan	14.4
West Germany	11.8

France	7.3
Italy	6.4

[1] Assumes individual receiving $50,000/year in salary plus $49,000 of investment income: $10,000 in dividends, $5,000 in interest, and $34,000 in capital gains. The tax rate on the investment income is the tax rate over and above the tax imposed on the $50,000 in salary (the marginal rate).

For the $20,000 wage earner, the U.S. would fall to third place under a 10 percent cut in rates and would remain third highest under a full 27 percent cut even though the rate would be lower.

[2] Assumed 10 percent cut in tax rates: 30.6 cents. Assumed 27 percent cut in tax rates: 25.4 cents.

Sources: NYSE; Price Waterhouse & Co.

CONCLUSION

Our study has found a connection between the relatively low personal saving rate in the U.S. and the tax treatment accorded investment income. Professor Kendrick's analysis tells us that the major reason France, Canada and Japan have had faster rates of economic growth than the U.S. is because of faster growth of their capital stock and higher investment rates. We know that investment funds must come out of saving. Thus, since increasing saving and investment rates to boost productivity and economic growth are important goals, lowering taxes on investment income should have the highest priority of this Committee.

Senator PACKWOOD. Let's start with the panel of Edwin Cohen, Theodore Brophy, and Albert Cohen. Are they all here? All three of you? Both Mr. Cohens and Mr. Brophy?

All right.

Mr. Edwin Cohen, why don't you go right ahead?

STATEMENTS OF EDWIN S. COHEN, ESQ., CHAIRMAN, TAXATION COMMITTEE, CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY RICHARD W. RAHN AND KENNETH D. SIMONSON

Mr. E. COHEN. Thank you, Mr. Chairman. My name is Edwin S. Cohen. I am a member of the board of directors and chairman of the taxation committee of the Chamber of Commerce of the United States, on whose behalf I testify today.

I am a member of the law firm of Covington & Burling of Washington, D. C. and I am accompanied today by Richard W. Rahn, the chamber's vice president and chief economist and Kenneth D. Simonson, tax economist and acting director of the chamber's tax policy center.

The chamber's membership consists of 135,000 businesses, trade associations, and local and State chambers of commerce. On their behalf, we appreciate the opportunity to testify today in support of the tax aspects of the President's program of economic recovery contained in S. 683.

The board of directors of the chamber in a dramatic meeting several months ago, decided to lay aside their individual differences and unanimously concluded to endorse the President's program for budgetary control and tax reduction.

The board concluded that it was urgently important that the country unite behind the President's leadership and move quickly to reduce taxes to control the growth of Federal spending, to reform the regulatory process and to support a stable and moderate economic and monetary policy.

To this end the board endorsed the President's ACRS proposal and the across-the-board individual income tax reductions aggre-

gating 30 percent and spread evenly over the 3-year period beginning July 1 of this year.

While the chamber has endorsed several other proposals for changes in the tax law that have been pending before you, the board concluded that it is urgently necessary to enact these two principal changes promptly, without the necessary delays that would be involved in shaping the precise terms of the other changes the chamber supports.

With respect to the proposed capital cost recovery system, the chamber worked with other groups some 2 years ago in the development of a proposal in an effort to modernize and simplify our capital cost recovery system on a basis that would be fair alike to large and to small business, and which would improve our productivity, increase jobs and investment, and permit us to compete more effectively in the world markets.

We believe the ACRS proposal will serve to attain those objectives and is a vast improvement over present law and regulations.

It eliminates the need for trying to predict the future life of depreciable assets based upon a prior history that is necessarily outmoded when the assets are bought.

It eliminates the need for guessing about future inflation and interest rates. It provides certainty and simplicity in the preparation and audit of tax returns. It will enable the businessman and investor to know readily what would be the tax effects involved in the purchase of equipment, whether new or secondhand.

We have been arguing about depreciation and capital cost recovery systems since the beginning of the income tax law and we will never all agree upon a perfect system. The ACRS system has been developed after much careful study. It has the advantage of certainty and simplicity and we believe it will clearly spur capital formation and increase productivity and jobs throughout the country.

Similarly, the chamber strongly supports across-the-board reduction in individual income tax rates which it firmly believes is long overdue.

The ravages of inflation have relentlessly increased the tax rates on individuals as their incomes have been forced into higher brackets in order to match the increased cost of living.

In essence, we have, by inaction, raised the tax rates regularly for some 15 years. I need not recite to you the data which has been presented to you by so many others to demonstrate the unfortunate effect of this bracket creep upon workers and investors alike, on the initiatives of the private economy, on the willingness of the people of this Nation to assume financial risk and to exhibit the venturesome spirit upon which our economy was founded.

The vast majority of small- and middle-sized American businesses are unincorporated and pay taxes at individual rates. Not only will this across-the-board rate reduction benefit employees, but it will also benefit all of these businesses whose income is subjected to individual income tax rates.

Accordingly, Mr. Chairman, the chamber strongly urges the committee to endorse the President's proposals and promptly thereafter turn to the adoption of other changes that are also needed for the improvement of our tax structure.

Thank you.

Senator PACKWOOD. Thank you, sir. Mr. Brophy?

STATEMENT OF THEODORE F. BROPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP.

Mr. BROPHY. Mr. Chairman, my name is Theodore F. Brophy. I am chairman and chief executive officer of General Telephone & Electronics Corp. I also serve as co-chairman of the Business Roundtable and as chairman of its taxation task force and I am testifying here today in that latter capacity.

I have submitted a written statement and respectfully request that it be incorporated in the record.

Senator PACKWOOD. It will.

Mr. BROPHY. I will make some very brief comments. I do appreciate this opportunity to testify before you today on behalf of the Business Roundtable and in support of the President's tax proposals for business and individuals, specifically the accelerated cost recovery for business and the multiyear reductions in marginal rates for individuals.

It is critically important that the Congress act quickly on the President's tax proposals. I suggest that the apparent concern that has been evidenced in Wall Street recently is a strong indication of the need for prompt action. These concerns do not, I believe, represent dissatisfaction with the administration's program, but rather concerns about when and if that program will be passed.

I strongly urge the distinguished members of this committee and of the House Ways and Means Committee to work together to enact a tax bill before the August recess. Time is of the essence and may be critical to the successful implementation of the economic recovery program.

The economy's health requires more than a booster shot in the arm. It does require major surgery in the form of basic changes in Government policies.

The administration's economic recovery program represents that kind of basic change so desperately needed and for that reason, the Business Roundtable applauds the program.

The President's program, as you well know, involves four parts: the reduction in Government spending, the reduction in taxation, an easing of Government regulatory burdens and finally, a stable and consistent monetary policy.

Each of the four parts is, we believe, essential and interrelated and action must be taken on all of them if we are to solve our Nation's puzzling economic problems.

Your action on the first concurrent budget resolution represented a large first step in the right direction and I strongly urge you to continue down that path by enacting the President's tax proposals for business and individuals.

It is widely recognized that current tax depreciation policies are inadequate in today's environment and capital recovery needs to be greatly accelerated and tax depreciation simplified.

The administration's accelerated capital cost recovery system, known as ACRS, has been carefully fashioned to accomplish these

goals and has widespread support throughout the business community and in the Halls of Congress.

It would substantially increase business capital investment, and as we must modernize our productive capacity of America to permit American workers to do today's jobs with today's tools and not with yesterday's.

I strongly believe that ACRS must be enacted quickly and with an effective date of January 1, 1981, if it is to have the maximum possible benefits on the U.S. economy.

We also support the President's concept of a multiyear cut in marginal tax rates for individuals. The individual tax rate reductions at the margin would do many things to help heal our ailing economy.

They would lead to a reversal in the alarming decline in personal savings in the United States and among other things, they would remove the current restraint on incentives to work and invest caused by today's unrealistically high individual, marginal tax rates.

A multiyear tax cut is needed to produce the maximum benefit. A 1-year cut would simply not offset the bracket creep and provide sufficient encouragement to individuals to change their present courses of action.

We in the business community strongly believe that now is the time for Congress to begin the process of revitalizing the economy by passing the President's program.

If you do, I am confident that American business will accelerate its capital investments and together, we can get the economy back on the track.

Thank you very much.

Senator PACKWOOD. Thank you very much. Mr. Albert Cohen.

STATEMENT OF ALBERT COHEN, COUNCIL OF STATE CHAMBERS OF COMMERCE, ACCOMPANIED BY EUGENE RINTA

Mr. A. COHEN. Thank you. My name is Albert Cohen. I am a member of the federal finance committee of the Council of State Chambers of Commerce on whose behalf I am appearing today. With me is Eugene Rinta, who serves the council as consultant on Federal fiscal issues.

The council includes 34 member-State organizations, 33 of which have to date specifically endorsed the positions we will express here.

The administration has proposed a broad program for economic recovery consisting of a 3-year program of tax reduction, strong budgetary restraint, regulatory reform, and a stable monetary policy.

We are here today to comment primarily on the tax features of this program, but we believe we must also add our general thoughts on the matter of Government expenditure policy as well.

While we believe certain technical features of the specific proposals may require further attention, we strongly support the main elements of the administration's proposal. We urge the Congress to demonstrate its resolve to act positively, promptly, and decisively in response to the widespread public concern over inflation, declin-

ing productivity, lack of savings and investment, and deterioration of our competitive position in the world economy.

A clear signal of a dramatic change in direction in our tax and fiscal policies should not be delayed. Clearly, personal income tax burdens have become excessive with individuals at all income levels becoming subjected to higher marginal and average tax rates by inflation.

Reductions in individual taxes across-the-board with the top marginal rate of 50 percent and elimination of discriminate taxation of income from capital would encourage savings and investment to improve productive capacity, modernize and enhance our stock of capital goods, improve productivity, and relieve pressure on future price increases.

We strongly endorse the administration's proposal for the establishment of an entirely new system of capital cost recovery as a campaign piece to individual tax rate reductions.

The proposed accelerated cost recovery system would insulate capital investments against ongoing inflation, improve the economics of capital investment, contribute to increased employment opportunities and productivity, and be of special value to small businesses which have found the current system too complex and too rigid for them.

The administration's tax proposals would establish a new direction and would reverse several decades of encouraging consumption at the expense of savings and investment and literally, of appropriating through taxes, a portion of the Nation's business capital.

We strongly endorse prompt enactment of these two fundamental tax proposals contained in the administration's program.

The foregoing relate to tax policy. We must add our brief thoughts on the Federal Government's role on the spending side as well.

We have been greatly encouraged by the favorable response in the Congress to Federal spending restraint and we urge that the anticipated opposition by special groups not distract from the broad national goals that demand restraint.

As an essential part of attention to spending restraint, we urge prompt congressional restructuring of present inflation adjustments on various entitlement programs.

We thank you for having been afforded this opportunity to express our views on these important issues. If there are any questions, Mr. Rinta or I will be pleased to respond.

Senator PACKWOOD. Thank you. Senator Bradley?

Senator BRADLEY. Yes, Mr. Chairman. I would like to ask the panel about the 10-5-3 proposal. That is the one that has received a great deal of attention in the committee. Yesterday, we had quite a few businessmen and economists come in and testify about it.

What I am curious about is that if we figure inflation were to fall to around 6 to 7 percent, which is what is projected by the administration, would 10-5-3, in such a circumstance, result in a negative effective tax rate for certain kinds of investment in your judgment? You have combined the interest cost plus the depreciation?

Mr. E. COHEN. Senator Bradley, if you assume whatever figures you want about the actual life of property, about inflation rate, and about interest rates, you can reach that conclusion.

I think this is a conclusion that is not necessarily strange to the income tax law. We have had it in some other directions as well.

For example, with respect to deductions for wages paid, an expense immediately deductible in most circumstances, we also have a jobs credit, so an employer who avails himself of the jobs credit is in that sense subjected to a negative income tax rate because he is getting a full, immediate deduction for the expense and is getting a credit besides.

There are other illustrations, but I dont think there is anything necessarily strange.

Senator BRADLEY. Does it bother you that there are differences in the tax rate among categories of assets? If you have several categories of assets taxed at different rates wouldn't that bias investment decision?

Mr. E. COHEN. That depends upon your assumptions. As Senator Long's—I was at the Treasury at the time when we had the last major revision of depreciation policies in 1971 when we developed the ADR system and we were acting within the restraint of the existing statute to do what we could by regulation. We decided at that time to permit a 20-percent leeway in the depreciation life.

The problem that you have in every one of these instances is to determine the relative lives of property. If you have property that has an estimated 20-year life and I have one that has an estimated 3-year life and they are both going to have a 5-year life for tax purposes, we conclude that that is not necessarily correct. You may figure that your depreciation will be different from mine.

We can argue interminably what the life should be. I went through the files of the Treasury when the lives were established last in 1962 and having examined those files, I can tell you that there is no precise science in the determination of those lives.

Senator BRADLEY. Well, doesn't that kind of complexity and distortion argue for simply expensing?

Mr. E. COHEN. Not necessarily; expensing isnt any more correct then 5 years would be. Expensing would mean that all assets would be immediately expensed, but they would all be treated alike regardless of what your assumption was as to their life.

Whether you had expensing, which is 1-year life, or 3-year life, or 5-year life, they are all treated alike. So, I dont think it necessarily argues for adoption of the 1-year life as against the 5-year life.

Senator BRADLEY. Wouldnt that eliminate the problem of inflation though in the question of depreciation?

Mr. E. COHEN. Well, it eliminates the problem of inflation, but I think there are other problems such as that a 1-year life may be that it is too generous, and so the 5-year life, like much of the tax law, is a compromise of opposing views, and one could also take into account that if you had expensing and a 10-percent investment credit that quite clearly involves a negative tax rate. A 5-year life with an investment credit is, at least arguably, not any better than direct expensing.

Senator PACKWOOD. Let me stop you there, Bill, so Russell can ask some questions before we have to stop.

Russell?

Senator LONG. What you are recommending to us for a five life, would give absolutely nothing to somebody who already had a piece of equipment that actually had a 5-year life. Zero. It means something to a fellow with a piece of equipment with 18 years or for 10, but the fellow with 5—you have done absolutely nothing for him. Is that correct?

Mr. E. COHEN. That is correct.

Senator LONG. He is just as well off under present law.

Mr. E. COHEN. He may be just as well off. He will be as well off as under present law. Whether he is being taxed correctly or incorrectly under present law is debatable.

Mr. BROPHY. He will, of course, have the benefit of the full investment tax credit on the 5-year life.

Senator LONG. Let me tell you what bothers me more about the group that you fellows are speaking for.

It is this fixation on the theory that even if somebody shows up with something that is clearly superior to what you are advocating, don't consider any amendments. Eleven hundred organizations here backing you up, saying no amendment.

Let's just take the expensing thing for the moment. Let's just assume for the sake of argument that we say, well, we have so much revenue to work with and that is how you should do when you are down there at the Treasury, Mr. Cohen. I have many times used you as my source to prove a point.

If we assume that we have x amount of revenue that you can afford to work this type thing and the Treasury usually thinks in those terms until the President finds himself thinking in those terms and so do we.

If we say all right now, whatever we can afford, let's put it into a system where you dispense it all. Just pay it all out the first year. Now, so far as I know, up to this point every witness who has testified on that has said well, if you can do it that way, that would be preferable to the 10-5-3.

But, one very simple reason that you would be well familiar with, Mr. Cohen, is that you have to write this piece of equipment off over a 5-year period, then everytime you buy a new piece of equipment it starts on a new schedule even though it is a 5-year. You have to say all right, now this piece was bought 2 years ago so its x amount.

There is a great deal more accounting. Now, assuming that what we try to do for business is going to cost the same amount and be the same benefit to business in either event, if you are thinking in those terms, to just write it all off the first year caused the problem.

You don't have to keep up with what year you bought the equipment and all the rest of that. Goodness knows how much bookkeeping you save with all that, even if we can't let you write the whole thing off, you say well, if you get 95 percent of it and you write that off the first year, that is it.

Now, but whether you use the 10-5-3 or whether you use the expensing approach, in either event you come to problem No 2. That is that this bill under the depreciation schedule puts it within the capability of most companies and most high bracket taxpayers

to eliminate their tax liability entirely. You use this particular thing as a tax shelter. What do they pay us? Nothing.

I can recall a time when they had that potential and I would plead with businessmen, the fact that you have that power to do that type thing does not mean you ought to do it. You will have the whole business community held up to probing and scorn when you do it.

Notwithstanding, their taxing job is zero because they have that potential and some of them, I regret to say, were in the oil and gas business, so some of them were resentful when I said well, you don't get the full benefit of depreciation and intangibles if you to do so means that you are going to wind up owing us nothing.

Now, that aspect ought to be taken into account in any respect. Now, you are here to support President Reagan and you wish him well I am sure if you want to run for reelection. I would assume that most of the people who have been testifying here would like to see the man elected. If we fix this thing so that by the time we get through cutting welfare, social security, cutting down on disability and whatever else we are looking at, and then we say well, we did all this and fixed it up so the millionaires pay a tax only if they feel like paying us something.

You know we can't defend that to the American people. That is anybody who is in this administration can do it. They would say what did they do? They fixed it up so that the poor get cut, slashed about tens of billions of dollars worth they get and what do they get with it? A program where what the millionaires pay if anything is purely a voluntary contribution to their Government. Kind of like it being a charity.

Now, we can't have that and you know that. Isn't that right? Or do you quarrel with that? You wouldn't want that. Or would you?

Mr. E. COHEN. No.

Senator LONG. Let me say, if Mr. Cohen can't answer that question, nobody can.

Mr. E. COHEN. I didn't say I can't answer it, Senator.

Senator PACKWOOD. Let me stop you just a moment. I want to ask unanimous consent simply to put one statement in the record from Brian O'Connell of the independent sector and we do have a vote on with about 7 minutes left.

Senator LONG. Well, he has time to answer this question before the 7 minutes are up.

Mr. E. COHEN. Might I make just one comment?

Senator LONG. Both of you. I would like to know what both of you think.

Mr. E. COHEN. Perhaps, I could go first then.

First of all, on the expensing, I think expensing means many things to many people and if the Jorgenson-Auerbach approach is an expensing approach, it really introduces a new complexity to the tax law with 35 classes, the need to continue to examine useful lives. So I think how you go about expensing is a very important element as to whether or not expensing could be a possible satisfactory approach.

Senator LONG. Well, we are talking about having one class.

Mr. BROPHY. If you have one class for expensing, then you have to establish a useful life for that class and an interest for that class.

Senator LONG. Well, suppose we can't afford to give you 100 percent expensing for one class? Ninety-five percent for all of it. You can just write all off and you can depreciate 95 percent the first year.

Mr. BROPHY. Clearly, to the extent that companies have income that can use expensing, I suggest that you create, perhaps even to a greater extent, the problem you are concerned about of reducing or having a negative tax rate by going to full expensing.

Senator LONG. Well, that is why even if you have 10-5-3 we are still going to have to go back and take another look at the minimum tax.

Mr. BROPHY. Can I say one other thing on that, Senator? Over the years, I think corporations have unfortunately been substantially overstating their income and paying a tax on that which resulted in serious decapitalization of industries and that is particularly true of the industry that I am in.

Nobody has complained about that aspect of the tax law in the past. Really, we are talking here about deferral of tax as we accelerate depreciation, not an elimination of tax. Really a question is not what tax should a company pay, but the first question is what are the earnings of the company? If the company has no real earnings, then I don't see anything insidious about it paying no taxes.

So, you really have to determine what depreciation deductions are appropriate in determining what the earnings are for tax purposes. I don't think the 10-5-3 is an inappropriate determination of the earnings and surely the present system we have has resulted in a very, very substantial overstatement of earnings—companies paying dividends out of earnings, companies becoming very seriously decapitalized.

Senator LONG. I have to leave.

Senator PACKWOOD. We will recess until 2 p.m. this afternoon.

[Statements follow:]

PREPARED STATEMENT OF EDWIN S. COHEN

My name is Edwin S. Cohen. I am a member of the Board of Directors and Chairman of the Taxation Committee of the Chamber of Commerce of the United States, on whose behalf I am appearing today. I am a member of the law firm of Covington & Burling, of Washington, D.C., and I am accompanied today by Richard W. Rahn, the Chamber's Vice President and Chief Economist, and Kenneth D. Simonson, Tax Economist and Acting Director of the Tax Policy Center.

On behalf of the Chamber's 135,000 business, trade association, and local and state chamber members, we welcome this opportunity to present our analysis of the tax aspects of the president's Program for Economic Recovery which are contained in S. 683.

SUMMARY

The U.S. Chamber has endorsed the President's Program for Economic Recovery in its entirety. Congress must move quickly to reduce taxes, control the growth of federal spending, reform the regulatory process, and support a stable and moderate monetary policy.

The combination of inflation and rising effective tax rates has left savings and investment at inadequate levels. This low rate of capital formation contributes directly to falling productivity, erratic economic growth, and an objectionable rate of unemployment. Moreover, the rise in individual tax rates continues to erode

confidence in the tax system, and threatens to accelerate tax avoidance efforts at all income levels if left unchecked.

Adoption of the Administration's tax proposals, contained in S. 683, the Economic Recovery Tax Act of 1981, would lead to rapid, sustained economic growth by reducing disincentives for the private sector to work, save, and invest. Accelerated capital cost recovery would promote higher levels of investment, employment, and output by all types and sizes of business, while proportionate reductions in all individual income tax rates would encourage personal savings and reduce growing taxpayer resentment.

Prompt action on the Administration's program is essential. For this reason, the Chamber urges this Committee to report out a "clean" bill. Consideration of other tax provisions, many of which we support and would work to attain, should be deferred until S. 683 has been adopted, but should then be given prompt attention in the ongoing work of the Committee.

THE NEED FOR PROMPT TAX RELIEF

Last July, we testified before this Committee that "tax relief is warranted by the need to reverse the decline in productivity, to promote capital formation, to create jobs, to curb the unprecedented increase in the federal share of gross national product, and to improve our ability to compete for international markets." The need for tax relief has not lessened since that time.

The recovery from the mid-1980 recession is already showing signs of evaporating, and the economy may be heading into another downturn. Most forecasts for 1981 show increased unemployment, inflation at or close to double-digit levels, and only slight increases in productivity and real output.

Prompt enactment of the President's program would reverse these unfavorable trends. The most recent U.S. Chamber Economic Forecast shows that with the Administration's program in place, there would be an improvement in the economy, a drop in unemployment and inflation, and a rise in productivity, real GNP, and workers' pay through 1983, the end of the forecast period.

Tax relief and inflation

The proposed tax cuts would help reduce inflation, as would the rest of the President's program. The Accelerated Cost Recovery System (ACRS) would enable businesses to modernize their plant and equipment, produce goods and services more efficiently and allow workers to be more productive—all of which changes would be deflationary.

The individual rate cuts would encourage more saving and investment because they would leave people more money out of which to save and would enable people to keep more of the money that their investments earn. The rate cuts would decrease tax expense and thus would encourage an increased demand and supply of labor. Finally, because most business is taxed at individual rates, the rate cuts would improve cash flow and increase business expansion. All of the these effects would lead to higher output without an increase in cost, also a deflationary outcome.

Thus, ACRS and individual rate cuts together would raise both demand and supply of capital and labor, thereby contributing to greater output and higher productivity without adding to inflation.

At the same time, stable and moderate growth of the money supply would assure that inflationary monetary growth abates. In addition, the spending and regulatory restraint the Administration seeks would reduce government interference and competition with the private sector for resources, thereby both aiding private expansion and reducing pressure on the Federal Reserve Board.

The public seems well aware that individual tax rate reductions would reduce inflation, not add to it. A newpoll conducted last month by Opinion Research Corporation of Princeton, New Jersey, and funded by the U.S. Chamber, found that by nearly a 2-to-1 margin (57 percent–31 percent) the public believes that the tax rate reductions of 30% spread over three years would reduce inflation, rather than add to it. Democrats as well as Republicans expressed this view.

Tax relief and a balanced budget

A balanced budget is desirable, and the Administration's proposed tax and spending cuts together would achieve this by 1984. But the tax cuts are an essential part of the plan to balance the budget, because the tax cuts would help get the economy moving again. Delaying the tax cuts would not necessarily lead to a balanced budget any sooner, but would cost the economy dearly in terms of slower growth and lower savings, investment, employment, and productivity.

Surprising as it may sound, allowing tax rates to rise does not help bring about a balanced budget. Under the last Administration, the federal tax rate rose from 18.3 percent of gross national product (GNP) in fiscal 1976 to 20.3 percent in fiscal 1980, yet the budget was still almost $60 billion in deficit last year. President Carter's last budget, submitted in January, foresaw a steady rise in the tax rate to 22.8 percent in fiscal 1984, but no end to deficits before that year.

In contrast, President Reagan also would balance the budget in fiscal 1984. But he would do it by sharply slowing the growth of taxes and spending, thus encouraging greater private activity and more economic growth. In turn, the faster economic growth would result in the creation of more private jobs and higher real incomes, thus further reducing the demand for government transfer payments and social services. The twin effects of higher receipts from a stronger economy and lower demand for government social spending still would enable the budget to be balanced by 1984. But the government would take only 19.3 percent of GNP that year under President Reagan's plan, leaving taxpayers an additional $150 billion. Tax cuts and a balanced budget can and should be achieved simultaneously.

CAPITAL COST RECOVERY

The Chamber has worked with other business groups since 1979 to develop a new system of capital cost recovery that would promote capital formation, increase productivity, and create jobs, while providing major simplification of the outmoded depreciation provisions of current law. The result of this effort, the "10-5-3" proposal, has enjoyed widespread support throughout the business community and in the Congress, and we are pleased that the Administration has based its proposed ACRS on this concept. We remain convinced that this is the best way to provide simple, fair accelerated capital cost recovery.

The Chamber shares the concern expressed by the Chairman and Ranking Minority Member of this Committee that businesses could delay investment until completion of Congressional action on a tax bill. The March 11, 1981, joint statement that the tax-writing committees intend to make any depreciation changes effective no later than that date serves as a useful signal to business. However, we would urge that the effective date of capital cost recovery be the date proposed by the Administration, January 1, 1981, to avoid the needless complexity for taxpayers and tax administrators that two different rules in a single year would cause.

ACRS

Like "10-5-3," the Administration's proposal simplifies the depreciation of buildings and equipment by divorcing their recovery periods from the concept of useful lives. All assets would be assigned to easily identified classes, with a built-in schedule of cost recovery over a fixed time period.

The cost recovery deduction to which taxpayers would be entitled varies among these classes of business investment: 3-year property—automobiles, light-duty trucks, and machinery and equipment use for research and development; 5-year property—all other tangible property which is not 10-year or 3-year property. Most equipment and machinery would be included in this class; 10-year property—industrial buildings, stores, and warehouses used by their owners, and public utility property with and ADR midpoint life of greater than 18 years; 15-year property—other nonresidential buildings, such as offices and leased stores and low-income rental housing; and 18-year property—residential rental property other than low-income.

A full 10 percent investment tax credit would be available for assets in the 5-year class and for public utility property in the 10-year class. Property in the 3-year class would be eligible for a 6 percent credit.

ACRS would be mandatory, would make no distinction between new and used property for depreciation purposes, and would ignore salvage value.

The recovery deductions for the 10-, 5-, and 3-year categories build in accelerated methods and a half-year convention. When the system is fully phased in, the annual recovery allowances would be as follows:

PERCENTAGE OF ORIGINAL COST CLASS

	10 yr	5 yr	3 yr
Recovery year:			
1	10	20	33
2	18	32	45
3	16	24	22

PERCENTAGE OF ORIGINAL COST CLASS—Continued

	10 yr	5 yr	3 yr
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		

Real property in the 15- and 18-year classes would be depreciated using the straight-line method. Component depreciation would be repealed for all categories of real estate.

Disposition of property of the 10-, 5-, or 3-year classes would result in the portion of gain that represents depreciation previously taken being taxed as ordinary income. The entire gain from the sale of property in the 15- and 18-year classes, however, would be treated as capital gains.

Fairness and simplicity of ACRS

The major advantage of ACRS is its fairness and simplicity. All structures and equipment would be placed in one of five classes, as opposed to the more than 100 classes that now exist. Distinctions based on minute and necessarily arbitrary differences between industries or uses of property would be swept away. All sizes of business would be able to use the same accelerated recovery schedule without having to hire expensive staff or outside accounting help. This would benefit the IRS as well as business by substantially reducing the time devoted to accounting for depreciation.

A business purchasing a new piece of equipment or machinery under present law faces numerous complexities regarding depreciation. The firm must first determine the useful life under Treasury guidelines, and whether the taxpayer's "facts and circumstances" warrant a significantly shorter useful life. For some assets, taxpayers may use lives up to 20 percent shorter than guideline lives under the Asset Depreciation Range (ADR) System, but most small businesses do not use ADR. The Treasury Department estimates that, while nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR in 1974, only 0.36 percent with assets of $500,000 or less did so. Many small businesses, while not attempting to use the ADR system, use accelerated depreciation methods, and the associated administrative burdens and costs can be significant.

For short-lived assets, the taxpayer must decide whether to depreciate the asset over a short period and thereby forego part or all of the investment tax credit, or choose a longer life with a higher credit. In some cases the firm must determine whether the asset has salvage value and adjust the depreciable basis accordingly. Numerous options exist for the choice of depreciation methods, and a taxpayer can switch from one method to another during the asset's useful life. Making such a switch may be advantageous from a tax standpoint, but switching adds further complexity. Finally, the taxpayer may be allowed to claim additional first-year depreciation, commonly known as "bonus" depreciation, which in itself involves considerable complexities.

Such complications may not be a major problem for the taxpayer who has sophisticated knowledge of the tax code or the ability to hire expert advice, but they do penalize many small firms, which often do not have such help. ACRS would remove these complexities, replacing them with a simple, uniform system that would put small business on an equal footing with firms that now have the advantage of expensive expert help. Taxpayers would be able to determine the cost recovery allowance for any asset by reference to a simple table, without needing to worry about choosing the proper useful life, method of depreciation, salvage value, tradeoffs, or bonuses. Finally, the certainly and clarity provided under ACRS regarding allowable deductions should reduce disputes with the IRS, which can be especially frustrating and costly for small businesses that do not have a full-time tax staff.

Obviously, some businesses would directly benefit more than others. But most firms receiving large benefits have been severely penalized up to now by the combination of inflation and overly long cost recovery periods, and ACRS would redress that wrong. And most firms that do not receive large direct benefits will gain through the greater prductivity and prosperity that ACRS would bring to their more capital-intensive suppliers or customers.

All sections of the country would benefit, as ACRS would enable firms in regions with experienced workers, but outmoded equipment, to replace and modernize their production processes. ACRS would apply to outlays for modernizing and rehabilitating older property, and to purchases of used property, as well as to new assets. These features should make ACRS as beneficial to firms having older plant and equipment as to ones in new locations.

Benefits to small business from ACRS

Small business would derive several direct benefits from ACRS in addition to the simplification and equal treatment with bigger firms discussed above. First, the ending of less favorable depreciation rules for used than for new assets would be especially important to some small businesses which tend to buy used property more than larger companies. Second, most small firms purchase less than $100,000 of equipment and machinery per year and would therefore be able to use the five-year recovery period for all such purchases immediately.

The combination of faster cost recovery and investment credits available under ACRS will provide improved cash flow, a major consideration for many small enterprises. The table below shows the improvements for a variety of assets used by small businesses. For each asset type, ACRS provides either greater acceleration or a higher investment tax credit.

	Recovery period (in years)		Investment credit (in percent)	
	Present law [1]	ACRS	Present	ACRS
Asset type:				
Automobiles, taxis	2.5	3	0	6
Light trucks	3	3	3.3	6
Heavy trucks	5	5	6.7	10
Data handling equipment	5	5	6.7	10
Office furniture, fixtures, equipment	8	5	10.0	10
Owner-occupied nonresidential buildings	30 to 60	10		
Leased nonresidential buildings	30 to 60	15		
Low-income rental housing	30 to 60	15		
Other rental housing	20 to 45	18		

[1] ADR lower limit.

This table actually understates the advantage of ACRS to small businesses, since many of them do not use the shortest permissible lives or the most accelerated depreciation schedule allowed by present law.

Furthermore, small companies benefit relatively more than large companies from an increased investment credit rate, because a dollar of credit offsets more taxable income at low tax rates than at high tax rates. For instance, a firm in the 17 percent corporate income tax bracket pays $1 of tax on each $5.88 of taxable income, whereas a firm in the 46 percent bracket pays $1 of tax on each $2.17 of taxable income. Thus, an additional $1 of credit offsets up to $5.88 of income for a small company, compared to $2.17 for many large companies.

INDIVIDUAL RATE CUTS

For individuals, the President has proposed an across-the-board reduction in marginal tax rates of approximately 30 percent, phased in over a three year period. In 1981, individual marginal tax rates would be reduced by 5 percent effective July 1. In 1982 and 1983, the marginal rates would be reduced by 10 percent each year. In 1984, there would again be a 5 percent reduction.

Presently, tax rates run from a low of 14 percent to a high of 70 percent. The proposed cuts would reduce these rates to a range of 10 percent to 50 percent. When fully effective, the proposal also would eliminate the need for the separate 50 percent maximum tax on earned income, since all income would be subject to a maximum rate of 50 percent. In addition, the cuts would have the effect of lowering the maximum capital gains tax rate for individuals from the current 28 percent to 20 percent. Many taxpayers, of course, would pay taxes on capital gains at rates below this amount.

The need for individual rate cuts

Federal income taxes now claim the highest percentage of personal income since the Vietnam War surcharge was in effect.

These rising tax burdens have contributed greatly to falling personal savings rates. Savings dropped from an average rate of 8.1 percent of disposable income in 1971-75 to a mere 5.7 percent in 1976-80. So far in 1981, the savings rate has dropped to below 5 percent. A 30 percent tax rate cut would make a dramatic difference in savings behavior.

Increased tax burdens add to taxpayer resentment as well. An annual survey of taxpayers conducted for the Advisory Commission on Intergovernmental Relations last year found that the income tax has displaced the property tax as the "least fair." The most effective remedy to these problems is an evenhanded, across-the-board reduction in individual tax rates, such as was enacted in early 1964 on the initial recommendation of President Kennedy and the endorsement of President Johnson.

Finally, high tax rates reduce individuals' willingness to take a job or to work longer. Fully 24 percent of the respondents to the new U.S. Chamber-Opinion Research poll said they would work more hours if tax rates were cut 30 pecent over three years. Only 5 percent said they would work fewer hours. While the remaining 71 percent either expected they would not change their hours or didn't know, it is impressive that nearly a quarter of the respondents would work more as a result of the rate cut. With a labor force of over 100 million, even a one-forth response rate would mean a great deal of additional hours of work in the economy.

An across-the-board rate cut is the most beneficial individual tax change possible. It reduces taxes for everyone on every dollar of income from all sources. This is the only tax change that reduces the penalty on earning additional income whether through working more, saving more, or investing more, as well as on the income people are already earning. It counteracts the tendency of inflation to push all taxpayers into higher brackets and insures that no one will pay more than half their income to the federal government after 1983.

Changes such as increasing the personal exemption or the zero bracket amount (standard deduction) may provide some relief, but they do nothing to encourage people to work or save more, because the additional income would still be taxed more heavily. Other changes give relief only to limited groups of taxpayers, such as tax reductions for specified forms of saving. Only across-the-board rate changes reduce all tax burdens proportionately.

Rate cuts and personal savings

Several new U.S. Chamber-funded studies clearly show that rate cuts would encourge more savings. The opinion poll cited above revealed that 82 percent of the people would use some or all of a 30 percent rate cut for saving or debt repayment rather than current consumption. The average amount that those people said they would save was 55 percent. Even among people whose family income was below $10,000, 75 percent said they would save some. Similarly, in an earlier Gallup-U.S. Chamber scientific survery of consumer attitudes toward taxes and spending, a majority of the respondents said they would "save most" or "save and spend about equally," given a 10 percent rate cut.

Another preliminary study for the U.S. Chamber by a respected consulting firm, Mathematical Policy Research, found that people at all income levels are likely to use about 70 percent of the rate cut in 1982 for saving and debt repayment, based on actual spending patterns followed in a 1972-73 survey of expenditures. The survey results were updated to reflect 1982 income, consumption, and population characteristics.

Finally, a study of the response of savings rates to tax changes over the period 1964-71 shows a strong and consistent pattern: the savings rate jumped quickly when tax rates were lowered in 1964-65 and 1970-71, and the savings rate fell just as fast when the tax surcharge was imposed in 1968-69. In particular, the rate cut of almost 20 percent proposed by President Kennedy which took effect in 1964 and 1965 was accompanied by a 50 percent rise in the personal savings rate by 1967. If these relationships still hold, the President's rate cuts will lead to a savings rate of 9 or 10 percent in 1984, representing $90 to $120 billion of additional saving that year over levels that would occur without a tax cut.

Benefits to business

While the rate reductions proposed by the President generally are viewed as benefiting individuals, they also would have a very positive effect on business, particularly small business. In 1977, over 14.7 million tax returns were filed by corporations (including subchapter S corporations), partnerships, and sole proprietorships. Of this total only 1.8 million, less than 12.5 percent, were taxable as corporations. In other words, the income of almost 90 percent of U.S. businesses is taxed at individual rates, and thus should benefit directly from the proposed reduction in rates.

Businesses, both incorporated and unincorporated, also would benefit from the simplification that reducing the top marginal rate from 70 percent to 50 percent would bring to the tax code. This change would eliminate entirely the need to distinguish between earned and investment income for purposes of the maximum tax on earned income. More importantly, it would reduce the role of taxes as a factor in selecting a form of business organization.

Moreover, individual rate cuts would have positive effects on investment, both corporate and noncorporate. The lower rates mean that investors would get a larger after-tax return on all types of investment income—dividends, interest, rents, royalties, partnership and proprietorship income, and capital gains. This would make many investments more attractive than they are at present tax rates.

Also, the reduction in rates on the upper brackets would make fully taxable investments relatively more attractive than tax shelters. Many tax shelters are attractive only to persons in tax brackets exceeding 50 percent. Once the rate cuts reduce the maximum tax on all income to 50 percent, many individuals would transfer their funds to more productive investment, leading to an increase in tax receipts and to the decrease in the use of tax shelters.

Fairness of individual rate cuts

The President's plan reduces tax rates by the same percentage for each income level. Naturally, this means larger dollar reductions in tax burdens for high income taxpayers, because they pay the overwhelming majority of taxes. This would still be true under the President's plan, but every taxpayer would pay less than under present law.

Furthermore, the share of total taxes paid by each income group would remain virtually unchanged. For instance, Treasury figures show that under current law individuals with less than $10,000 of adjusted gross income in 1984 would pay 2.2 percent of total income tax liability. Under the President's proposal they would pay 1.8 percent. Individuals with adjusted gross income of over $100,000 would pay 15.8 percent of total income tax liability under current law, 16.9 percent under the Reagan proposal.

CONCLUSION

The Chamber firmly believes that the need for prompt enactment of the Administration's tax program is clear. Tax burdens must be reduced if we are to reverse the pattern of declining productivity and personal savings rates. The adoption of the Accelerated Cost Recovery System, by raising the rate of return on investment, would stimulate additional capital formation. A 30 percent reduction in marginal tax rates would reduce the current disincentives against greater work effort, saving, and investment by individuals, and would benefit a great number of noncorporate business taxpayers.

Once these changes have been enacted, Congress should promptly begin work on other tax changes. A second tax bill should contain provisions to reduce corporate tax rates, address the problems of small business, further increase savings, improve the tax treatment of Americans working aboard, and reduce the so-called marriage penalty. We look forward to assisting the Committee in this effort.

PREPARED STATEMENT OF THEODORE F. BROPHY

Mr. Chairman, distinguished members of the Committee. My name is Theodore F. Brophy. I am Chairman and Chief Executive Officer of General Telephone & Electronics Corporation. I serve as Co-Chairman of The Business Roundtable and Chairman of its Taxation Task Force. I sincerely appreciate the opportunity to testify before you today on behalf on The Business Roundtable in support of the President's proposal to provide an across-the-board, marginal, multi-year tax rate reduction for individuals and accelerated capital recovery for businesses.

The Roundtable is a business organization comprised of the Chief Executive Officers of approximately 200 corporations. The corporations represented provide millions of jobs for our work force and billions of dollars of capital required to support our country's economy.

Existing government policies have stifled our economic growth and contributed significantly to the current high rate of inflation. Our rates of savings, investment and productivity growth have all been lagging in recent years, signaling economic problems for the future. The Roundtable is vitally concerned about the long-term economic health of our nation and believes that all four aspects of the President's Economic Recovery Program are essential to revitalize the domestic economy, keep our nation competitive in the world marketplace and improve the standard of living for all of our citizens.

The President has proposed a far-reaching program that calls for a reduction in Federal government spending, taxation and regulation and a stable, consistent monetary policy. The business community feels strongly that all four parts of the economic recovery plan are essential, interrelated and must be acted upon in order to break the interlocking cycle of inflation, slow economic growth, poor productivity performance and inadequate capital formation.

The business community has for the past several years been advocating the enactment of fundamental changes in our tax laws to stimulate savings, investment, capital formation and individual initiatives. At the same time we believe that such changes should be accompanied by a decrease in the rate of growth in Federal government spending so as to release a greater share of national output (GNP) for productive use by the private sector.

Both Houses of Congress must be highly commended for the forthright and courageous action that was taken in recent days with respect to the first concurrent budget resolution. Large budget deficits year after year have contributed to excessive growth of the money supply which has fueled inflation and driven interest rates to historic highs. By taking decisive action to regain control of the Federal budget the 97th Congress has provided a clear signal to the American people that the Federal government is determined to win the battle against inflation and we believe that such action, when finally implemented, will yield benefits in the form of: Improvement in the management of the government's financial affairs, decrease in the pressure to expand the money supply at a rapid pace, reduction of inflationary expectations, and strengthening of the free market system.

Carrying out the mandate of the recent budget resolutions at the committee level will not be an easy task. It represents a significant change in the direction of Federal government policy. When major change takes place, there is concern and even danger that certain elements of society will be affected more than others, particularly with government as large and omnipresent as ours. However, implementation of the proposed spending reductions, when combined with the other aspects of the President's Economic Recovery Program, will provide us with a healthy, growing economy on a long-range basis—the best protection for all individuals.

THE NEED FOR ECONOMIC GROWTH

The need for a multi-year, across-the-board reduction in the marginal tax rates for individuals and faster write-offs of capital investments by business becomes clear when one examines our inadequate rate of capital investment and our poor rates of personal savings and productivity.

Certainly, you are all familiar with the statistics that show a gradual deterioration in our economy's ability to grow over the past decade. The relative economic performance of the United States, as compared to the other major industrialized countries, in the important areas of real GNP growth and productivity, inflation and employment has ranked near the bottom of the scale. A slowdown in the development of new technology and excessive government regulation have contributed significantly to our lagging productivity growth and low rate of capital investment.

Productivity is the ultimate determinant of whether our standard of living goes up or down. Improved productivity does not mean that everyone must work harder, but it does means we should find ways to work more efficiently. One of the important ways to improve productivity is to invest in new plant and equipment. Innovation and creativity must be encouraged. Our percentages of GNP going into research and development have been declining, and we must reverse this trend.

It is not surprising that in the current economic climate with real incomes for individuals falling, people have saved less in an attempt to maintain previous levels of consumption. Our personal savings rate is at a 30-year low, adversely affecting many areas of our economy that depend on personal savings to provide funds for private investment. A recent study performed by an international accounting firm for the New York Stock Exchange concluded that the low U.S. savings rate appeared to be linked to the comparatively heavy U.S. tax burden on investment income. Tax policy plays an important role in the decision to save, and less burdensome taxation of investment income clearly would encourage increased savings.

ECONOMIC GROWTH THROUGH TAX REDUCTION

A large part of the blame for our poor economic performance during the past decade can be placed on a tax structure that has been directed toward increasing consumption, in the process discouraging savings, investment and individual initiative. As an integral part of his overall economic recovery strategy, the President has

proposed two broad-based, fundamental changes be made to our Federal tax system: An across-the-board individual tax rate cut, to be phased-in over a three year period, and a liberalization and simplification of the present system of capital recovery.

Individuals have been suffering a serious deterioration in their standards of living as a result of the interaction of our progressive income tax rate structure with the high rate of inflation. At the same time unrealistic capital recovery allowances for businesses have impeded our productivity growth. The Roundtable is fully supportive of the President's tax proposals and believes that their enactment will: Create jobs, reduce the tax barriers to work, save and invest, improve our country's competitive position in world markets, lay the groundwork for long-term real economic growth, and help secure a higher standard of living for all Americans.

We do not view these proposals as "tax cuts" since they only act as a partial reduction of large scheduled increases in income and social security tax collections. These measures are aimed at increasing capital formation, improving the climate for business investment, providing incentives for individuals to work and save and promoting economic stability necessary for long-range planning. The proposed tax changes would place national tax policy on a sensible new course.

Beyond these measures, we recognize that there are a number of other areas of the tax law that have acted as disincentives to savings and investment and that, if changed, would enhance the long-term economic outlook for our economy and our citizens. The Administration has committed itself to the introduction of a second tax bill that would address these additional structural problem areas. The Roundtable supports the Administration's position of limiting the first tax bill to critical major items. We will be prepared to offer our recommendations for items that should be included in a second bill at the appropriate time. With Federal revenues increasing by a projected $86 billion and $104 billion for fiscal years 1981 and 1982 respectively, tax cuts of the magnitude and scope proposed would seem appropriate.

The Federal tax burden on individuals has grown at an alarming rate in recent years. As inflation in the 1970's pushed people into higher tax brackets, a new word became deeply embedded in our vocabulary—"bracket creep". This phenomenon had not been anticipated when the tax code was drafted. President Reagan has proposed breaking this vicious cycle with multi-year reductions of marginal tax rates. Many decisions to work, save or invest are made at the margin and the success of the President's program hinges on cutting marginal rates.

The multi-year aspect of the individual rate cut is also critical to its effectiveness. A one-year tax rate reduction would not have a sufficient impact on the rate structure to reduce the heavy weight presently given to taxes in investment and consumption decisions. The Administration's approach would increase the stability and certainty in the Federal tax system and be extremely beneficial in long-range planning decisions.

The across-the-board tax rate reduction serves other purposes besides capital formation, so it is not claimed that there will be universal dedication of these tax reductions to savings. It is anticipated that a substantial amount of this tax reduction will be saved. This broad-based approach will: Lead to a reduction of the maximum capital gains tax, reduce the maximum tax on investment income, lessen the tax on unincorporated small business entities, and reduce penalty tax rates on dividends and interest.

These are desirable and fundamental changes to our tax structure which will increase savings and yield positive long-term benefits to the economy at a minimum of cost. Reduction of marginal tax rates will stimulate work effort and will reduce the incentive to invest in tax avoidance schemes.

It is widely recognized that current tax depreciation policies are inadequate and need to be accelerated and simplified. The Accelerated Capital Recovery System (ACRS) proposed by the Administration, basically a modified version of "10-5-3", has widespread support throughout the business community. Of course, as you know, this concept has had considerable sponsorship for several years in Congress from both sides of the aisle. Current tax depreciation based on historical cost and utilizing the "useful life" concept is not responsive to the economic environment of today. Write-offs of the original cost of purchased plant and equipment do not provide sufficient deductions to recover the inflation-driven replacement costs. Furthermore, the useful lives assigned to these assets by technical considerations fail to take into account critical economic factors such as obsolescence, the impact of new technology and changing competitive conditions.

The enactment of ACRS would go a long way toward ending dependence on the "useful life" concept and would: Improve rates of return on captial investments and the risk/reward ratio of such investments, enhance business cash flow, an important source of funding for private investment, provide relief to the capital markets and the precarious financial condition of many corporations, and reduce the com-

plexity of the depreciation rules, which would be particularly beneficial to our smaller businesses.

The need for enhanced capital recovery is clear. ACRS is responsive to that need and should be enacted with an effective date of January 1, 1981. The sooner this legislation becomes effective, the sooner its beneficial impact can be felt on our beleagured economy. The revenue effect of ACRS is limited in its initial years, and feedback stimulus to the economy will help to offset the cost in the out-years.

The Roundtable is fully supportive of ACRS. Its enactment would provide a dramatic improvement over current law. If technical modifications were to be introduced to this legislation, we believe it could be strengthened in several ways: ACRS should provide more flexibility to the taxpayer and not mandate the maximum amount in every case, ACRS is a broad-based proposal and should not discriminate against any particular industry. All industries should receive equal capital recovery treatment under this system, and ACRS should not provide less capital recovery to any company than it is currently receiving under existing law, as may be the case with respect to U.S. companies with branch or subsidiary operations located overseas.

POTENTIAL BENEFITS OF ECONOMIC RECOVERY PROGRAM

Can the Administration's economic game plan work? Will it provide us with the essential productivity improvements and real economic growth on long-term basis that we so badly need? The President's program is multi-faceted in concept and geared to meet the challenge. The Roundtable believes that the approach of combining tax cuts with spending cuts is a sound one. Recent budgetary action by the Congress has greatly enhanced the possibility that the Administration's program will succeed in achieving its goals. Tax reduction must be aimed at encouraging more capital formation, and fiscal restraint will lessen the pressure to overexpand the money supply, thereby freeing up more capital for use by the private sector, lowering interest rates and reducing inflationary expectations.

History can provide us with some insight into the probability of success for the Administration's tax program. In the early 1960s, a series of tax cuts, including reduction of individual tax rates that averaged 20 percent and brought the highest marginal rates down steeply, a 10 percent reduction in corporate income taxes and improved capital recovery that included depreciation relief and the introduction of a 7 percent investment tax credit—created one of the strongest capital spending booms in recent history. A recent Joint Economic Committee study of these tax cuts has confirmed their positive impact on real GNP growth, employment and the personal savings rate. When tax depreciation was again accelerated in the late 1960s, it stimulated capital spending in the early 1970s, with capital spending averaging 11 percent per year in 1972 and 1973.

Looking back to some of the dire predictions of revenue loss, as much as $2 billion per year, which accompanied the 1978 capital gains tax reduction and comparing those predictions with actual results is an interesting exercise. As you remember, the maximum capital gains tax rate was decreased from about 49 percent in 1978 to 28 percent in 1979. Revenue from capital gains is now estimated to have risen $900 million per year in 1979 and 1980.

President Reagan's Economic Recovery Program provides us with an opportunity to reverse the direction of our national economic policy and begin the journey back to a healthy and prosperous economy. Economic recovery will not occur overnight, but we believe that the President's program provides us with the proper strategy for achievement of our goals. I urge this Committee to provide essential leadership to the Congress in moving forward with the President's tax reduction proposals.

PREPARED STATEMENT OF ALBERT H. COHEN

My name is Albert Cohen. I am a member of the Federal Finance Committee of the Council of State Chambers of Commerce and am a partner in the firm of Price Waterhouse & Co. With me is Eugene F. Rinta, who serves the Council of State Chambers of Commerce as consultant on federal fiscal issues.

We appear here today on behalf of the Council's Federal Finance Committee and member organizations of the Council which have advised us of their endorsement of the recommendations that we present herein. These member organizations are listed at the end of this statement.

The Administration has proposed a broad program for economic recovery embodying the following main elements:

(1) A tax program designed to spur savings, investment, employment, and productivity, and to address the unlegislated tax increases which have taken place through

"bracket creep" as the result of the unprecedented inflation we have experienced in recent years.

(2) Strong budgetary discipline on the expenditure side to seek to control the inflationary effects of growing budget deficits.

(3) Reform of the regulatory process to eliminate needless restraint on the productive process in our economy and to seek a more reasonable cost-benefit relationship.

(4) Support of a stable and moderate monetay policy.

We are here today to comment primarily on the tax features of this program, but we believe we must also add our general thoughts on the matter of Government expenditure policy as well.

The Administration's tax proposals presently before your Committee consist of two major elements:

(1) Across-the-board reductions in individual tax rates aggregating approximately 30 percent to be scheduled over a period of three years, and

(2) Establishment of a new system of capital cost recovery to replace the existing depreciation systems provided in the Internal Revenue Code.

We strongly support these elements of the Administration's proposals. While we believe certain technical features of the specific proposals may require further attention in the legislative process, we urge the Congress to demonstrate its resolve to act positively, promptly, and decisively in response to the widespread public concern over inflation, declining productivity, lack of savings and investment, and deterioration of our competitive position in the world economy.

Many other policies and technical issues in our present tax structure need to be addressed, and should be, in due course, but the clear signal of a dramatic change in direction in our tax and fiscal policies that is inherent in the proposals before you should not be delayed. We further believe the Congress should enact a clear course of tax rate reduction toward the ultimate goal of a maximum rate of 50 percent as an expression of its commitment to this goal and to provide visible support to and confidence in the conclusion that a new direction has, in fact, been taken.

INDIVIDUAL RATE REDUCTIONS

Clearly personal income tax burdens have become excessive, and personal income tax rates need to be reduced. Individuals at all income levels have been subjected to higher marginal and average tax rates by inflation, and the resulting increased tax burdens have contributed to growing taxpayer dissatisfaction, and a serious decline in personal savings rates.

As a step toward remedying these effects, the Administration has proposed enactment now of an across-the-board restructuring and reduction of tax rates over a three year period, reducing rates ultimately to a range of 10 percent to 50 percent.

Reductions in individual income taxes will encourage savings which in turn can make possible investments designed to improve productive capacity, modernize and enhance our stock of capital goods, improve productivity, and relieve pressure on future prices increases.

At the same time, reduction of the top marginal tax rate to 50 percent, and elimination of discriminate taxation of income from capital compared to income from personal services, will add a further incentive to investment in capital.

CAPITAL COST RECOVERY

As a necessary and harminious companion-piece to its proposals for individual tax rate reductions, the Administration has proposed the establishment of an entirely new system of capital cost recovery designed to reinforce the goals of promoting capital investment, increasing productivity, expanding employment opportunities, improving our competitive position worldwide, and combating inflationary pressures.

In essence the Administration's proposal would group most productive assets used in the United States into three categories with cost recovery periods of three years, five years, and ten years, respectively. Certain other property, primarily office buildings and residential rental property, would be assigned "audit-proof" capital cost recovery periods of fifteen or eighteen years. The proposed capital cost recovery system (ACRS) would take effect fully in 1985, with special transitional rules applying in the interim.

The proposed accelerated cost recovery system has distinct advantages over present depreciation systems, the most important of which are the following:

(1) For business requiring heavy investment in capital equipment, the shortened capital cost recovery periods would insulate against ongoing inflation.

(2) Improved cash flows will improve the economies of capital investment, thereby providing an incentive for capital investment which might otherwise not be made.

(3) The expansion of capital investment will bring about increases in employment opportunities and increased productivity, which will benefit all segments of the economy.

(4) Because of its fairness and simplicity, the proposed capital cost recovery system will be of special value to small businesses which have found the current Asset Depreciation Range system too complex and too rigid to use.

COMBINED ADVANTAGES OF RATE REDUCTION AND ACRS

Taken together, the combination of the proposed individual income tax rate adjustments and the strong encouragement of capital investment through the accelerated capital cost recovery system will establish an entirely new direction of tax policy for the United States. This new direction would reverse several decades of encouraging consumption at the expense of savings and investment, and of permitting taxation rules which, literally, appropriate through taxes a portion of business receipts which are not true income in the economic sense but are part of the capital flow necessary to maintain productive capacity. These policies have not only proved to be ineffective, but they have also contributed greatly to the inflationary climate we now have.

We strongly endorse prompt enactment of the two fundamental tax proposals contained in the Administration's program. Other changes of less broad significance, many of which are urgently needed, can be taken up later. We do not believe, however, that the fundamental elements of the proposals presently before you should be delayed.

The foregoing comments are restricted to the taxing side of the Federal Government's activities. To fully express our views on appropriate fiscal policy we must add our thoughts on the Federal Government's role on the spending side as well.

EXPENDITURE REDUCTION AND CONTROL

We have been greatly encouraged by the favorable response to Federal spending restraint expressed so far in both the House and the Senate. But we are concerned that opposition by special interest groups to specific reductions may yet distract from the broad national goals that demand restraint.

Accordingly, we urge early enactment of a budget reconciliation measure which will provide overall outlay reductions of the magnitude called for in the First Budget Resolution for fiscal year 1982. In that connection we were pleased to note the action of the Committee on Finance in approving 1982 outlay reductions in programs under its jurisdiction. These reductions totaling $10.3 billion in 1982 and $11.9 billion in 1983 compare with proposed cuts of $9.5 billion in 1982 and $11.0 billion in 1983 provided in the Senate's First Budget Resolution as reported by its Committee on the Budget.

In addition to the spending restraints already approved by your committee, we urge consideration of means for restraining the cost impact of present inflation adjustments on various entitlement programs under your jurisdiction. As the major cause of the sharp increase in the cost of entitlement programs during the last few years, the existing inflation adjustments clearly need reconsideration.

All but one of the 34 member State organizations in the Council of State Chambers of Commerce have to date subscribed to the policy recommendations in this statement. Additionally, a nonmember has advised of its desire to be listed as an endorser. The list of endorsers follow:

Alabama Chamber of Commerce
California Chamber of Commerce [1]
Colorado Association of Commerce and Industry
Connecticut Business & Industry Assoc.
Delaware State Chamber of Commerce
Florida Chamber of Commerce
Georgia Chamber of Commerce
Illinois State Chamber of Commerce
Indiana State Chamber of Commerce
Kansas Association of Commerce and Industry
Kentucky Chamber of Commerce
Louisiana Association of Business and Industry
Maine State Chamber of Commerce
Maryland Chamber of Commerce
Michigan State Chamber of Commerce
Minnesota Association of Commerce and Industry
Mississippi Economic Council
Missouri Chamber of Commerce
Montana Chamber of Commerce
New Jersey State Chamber of Commerce
Business Council of New York State, Inc.
Ohio Chamber of Commerce
Oklahoma State Chamber of Commerce
Pennsylvania Chamber of Commerce
South Carolina Chamber of Commerce
South Dakota Chamber of Commerce
State Chamber Division, Tennessee Taxpayers Association
East Texas Chamber of Commerce
South Texas Chamber of Commerce
West Texas Chamber of Commerce
Lower Rio Grande Valley Chamber of Commerce
Virginia State Chamber of Commerce
West Virginia Chamber of Commerce
Wisconsin Association of Manufacturers and Commerce

[1] November.

[Whereupon at 12:10 p.m. the hearing recessed, to reconvene at 2 the same day.]

AFTERNOON SESSION

Senator DURENBERGER [acting chairman]. The hearing will come to order. I understand that this morning our last panel Messers. Cohen, Brophy, and Cohen agreed to come back at 2 o'clock in case former Chairman Long or someone else had any questions of them.

Having missed your testimony, I don't have questions and I don't see anybody else present in the room so you can use your judgment, gentlemen, as to whether or not you would like to stick around or not.

I apologize to you for any inconvenience that may have been caused. From what I can see, there is no one up here that has additional questions of you.

I will just express my gratitude and that of the committee for the time that you have put into sharing with us your advice on this important subject.

Senator DURENBERGER. Thank you very much again.

Our next panel consists of Mr. James McKevitt, National Federation of Independent Business, Mr. William Barth, Partner of Arthur Andersen & Co. and a representative of the Small Business Legislative Council of the National Small Business Association and Mr. Allen W. Neece, Council of Small Business United.

We are missing one panelist?

Let me just start by saying, I haven't been here very long, but I feel like we have been through this process a number of times with you gentlemen and the organizations that you represent.

If you were here this morning, for Russell Long's comment on the one-bill, two-bill issue, I think you can understand some of the frustration some of the people feel having taken a substantial crack at the issues and the problems presented by tax reform last July and August with your help and having built a framework around tax reform, we are now trying to adjust to either the psychology of politics or something in readdressing the same subject.

Just in starting, I would express my personal appreciation to each of you and to the many small business people in this country that you represent for your persistence, for your dedication, for your willingness to keep coming back on both sides of the aisle and I just promise you that sooner or later the kinds of commitments that we all share are going to bear fruit.

So, let me just start in advance, by thanking you for your patience and your persistence and for being here today.

Your prepared statements, without any objection, will be made part of the record and you may feel free to either read those statements or to summarize them in some fashion.

On this list, Jim, unless there is another order, you go first.

STATEMENT OF JAMES McKEVITT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. McKEVITT. All right, Senator.

I would like to just read a brief summary of our statement. We have some new material since we saw you last. As you know, we mandate our membership every 6 weeks on business issues. It is

pretty difficult to determine how they break out on priorities of tax issues and so we did a random survey, 1 of 70 just recently. I just received the results last week.

This reflects how they break out so far as their interests are concerned in our brief statement which I will read.

NFIB's membership reflects the entire small business community. We have "Moms and Pops" and sophisticated high growth firms. We have capital intensive and labor intensive firms. We have new firms and mature firms. We have proprietorships, partnerships, subchapter S corporations, and corporations. They are in every city of every State in the country, not in just one region.

You name it, and if its small business we've got it. From our members we have learned that no one tax cut is a small business tax cut. It may be a small retailer cut or a small manufacturer cut but not a small business cut. Only a package of tax cuts can achieve this, Senator.

The No. 1 priority from our membership poll, was marginal rate cuts, reduction of individual taxes by reduction of marginal tax rates. This proposal will benefit many, many small businesses. Tax relief for many of the smaller incorporated businesses can only be achieved by basic tax reductions.

Over the last 10 years bracket creep caused by inflation has eaten away at the profits of these small businesses severely impeding their growth and often contributing to failure of the firm. Individual rate cuts is a very high priority for a majority of the small business community and should be an integral part or component of any tax package.

Two, a problem that we have talked about a long time is payroll taxes. In our survey a year ago, we found that of all the taxes bothering small business, inventory, sales tax, et cetera, payroll tax is at the top. So we have a high concern and always have the last several years for social security reform.

The high rates of social security contributions were mandated by Congress to forestall a cash shortage in the social security program. A similar program is now expected to occur during 1982.

Obviously, the social security system has structural difficulties that need to be addressed by Congress to stabilize the cost of running the social security program. Payroll tax relief would greatly help labor-intensive small business, the source of most new jobs.

Three, depreciation was rated very high in our survey. NFIB strongly endorses the 10-5-3 as the viable solution for depreciation. The 10-5-3 will allow small business to use accelerated depreciation rules on a scale never before available.

Additionally, the 10-5-3 system will assist the more capital-intensive firms by providing both a faster return on investments and reduced taxes which will lower financing costs and other small business concerns.

Clearly, the majority of the business community supports depreciation reform. Small businesses, prime concern is that depreciation reform results in a simple and a usable system. That is why we take issue with some of the alternatives which have been raised before this committee.

Maintaining any vestiges of either ADR or useful life as a concept of depreciation only insures complications in the tax law.

Another matter which we feel would certainly be of benefit to our members is allowing a cash method of accounting, which has

already gained the support of some of your colleagues here in the Senate.

For small retailers, wholesalers, and manufacturers the overevaluation of ending inventory causes overtaxation of profits. This overtaxation takes place because of inflation and the effect of price increases on inventory purchased for resale.

Smaller firms are squeezed and in practice receive discriminatory treatment under IRS regulations. The cash accounting method for small firms will alleviate their having to deal with inventories which would reduce taxes, lower professional fees, and reduce carrying costs in borrowing.

In 1976, Congress allowed farmers to use the cash method of accounting when the firm's gross sales were less than $1 million. The committee report cites one major factor in Congress decision, that the cash method of accounting is simple to use and to understand. The reasoning of the Congress was valid for small farmers, therefore, why not apply to all small businesses?

Senator Mitchell has introduced Senate bill 1180, a bill which encompasses many of the recommendations of the inventory accounting task force sponsored by Congressman Henry Nowak.

Obviously, a graduation of corporate income taxes rated high with our members who are incorporated. It does not have the universal appeal of our broad-based membership but has impact there.

Finally, estate tax reform—I see the yellow light on. Let me just summarize by saying that if you were going to bet on a horse that is coming up fast on the inside rail, estate tax is moving up very quickly. It has come from about fifth up to second. It is in win-place-show at third place right now. Growing, growing concern by our members to modify or get rid of the estate tax, or death taxes on the Federal and State level.

It is having a devastating effect on our members. One of our members, Wilbur Doyle in Virginia who has a lumberyard in southern Virginia, pays over 20 percent of his net profits in life insurance premiums.

Life insurance companies are doing well under the death taxes, Senator. Uncle Sam doesn't benefit that much from it.

Thank you very much, sir.

Senator DURENBERGER. Thank you very much, Jim.

OK, Mr. Barth.

STATEMENT OF WILLIAM BARTH, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. BARTH. Mr. Chairman, my name is William Barth. I am director of the small business practice of Arthur Andersen & Co. and I am here today representing the Small Business Legislative Council which is an organization of 82 small business and trade associations representing 4.5 million U.S. small business enterprises.

You have copies of my written testimony. You have an outline of that testimony. I would like to toss that aside and just talk to you face to face for a moment.

In preparation for today, Monday I met with 10 of my partners. We are CPA's.

These are the partners in our small business group. All they handle are small businesses. They probably have between 700 and 800 small business clients among them.

I asked them how they viewed the condition of the small business community; how small business was faring. They unanimously told me that their clients were hanging on by their fingernails at the moment in view of the high cost of money—probably 2½ to 3 times the amount of interest they were paying just a few years ago for the same amount of dollars.

We find companies are surviving today by a combination of several means. One is very, very severe belt tightening austerity programs.

Two, by rounding up all of the inventory that they can possibly get along without and liquidating those inventories.

Three, tightening receivables as tight as they can make them and four, making the old machine or that truck last for another year.

There is only so far we can go. My people tell me that their clients are at the end of the string and it is only a matter of months for many of them.

Yesterday, I met with the president of a major suburban bank in Chicago. I gave him this scenario and asked him if this was a correct accounting of the situation that prevails in the small business community.

He said yes, but with one exception; he is personally distressed that nearly every day he must ask an old customer to pledge his house for his business loan. He said, Bill, they are at the end of the string and I dont know where else they are going to go.

I just received an article by Alan Sinai who is the senior economist for Data Resources and he projects that interest rates in 1984 and 1985 will be 4 to 4½ percent higher then they are today.

Senator, my clients will not pay that rate because they won't be alive. They won't be here in 1984 or 1985 to pay those rates. Something drastically needs to be done to encourage capital formation in smaller companies. They do not have the public market to go to. There are very, very few of the tax suggestions which answer directly the problem of capital formation.

We agree and I do not take exception to increasing the graduated rate scale, lowering the taxes, writing off $25,000 of fixed assets; all of these are good measures. But, nearly all of them address only the preservation of capital. You have to have it and you have to make money and you have to owe taxes in order for tax reductions to be meaningful.

What we see developing is a series of operating losses of small companies and a trafficking in buying and selling companies for the sake of their operating losses. This is already being done. Companies already have their hit lists of other companies that they intend to swallow up which merely means further concentration of business in fewer and fewer hands.

I will say very quickly that over the weekend I fertilized my lawn and I know that nitrogen is good for it. You know they have numbers on the front of a bag. But, I dare not use only nitrogen, I would burn it up. What I am saying is the 10-5-3 program alone is pure nitrogen. We need other ingredients to go with the package.

Thank you very much.

Senator DURENBERGER. Thank you very much, Mr. Barth.

Allen Neece.

STATEMENT OF ALLEN W. NEECE, COUNSEL FOR SMALL BUSINESS UNITED

Mr. NEECE. Mr. Chairman, I am Allen Neece, Counsel for Small Business United, a consortium of 9 regional small business associations whose members are located in 25 States, including the great State of Minnesota.

Although not part of SBU, we also work very closely with the Small Business National Unity Council which is the follow-on organization representing the delegates who attended the White House Conference on Small Business.

Our overall objective, Mr. Chairman, is to persuade this committee to restore some semblance of neutrality to the Federal tax code. The code now serves as an disincentive for small business to attract and retain capital and to grow and prosper.

Inflation is squeezing the cash flow of small companies by pushing up costs, inflating the value of inventories, and expanding accounts receivables to such an extent it cannot afford to borrow, both of which my fellow witnesses have just testified to.

If they do increase their debt to equity ratios, they are often living on borrowed time because a downturn in cash flow prevents timely payment and servicing of that debt.

The only alternative is to either generate funds internally or turn to outside equity investors to meet the company's capital requirements. The tax code discourages the exercise of both of those options.

Closely held businesses suffer an additional burden as they have to use a large portion of their earnings to pay for insurance needed to satisfy estate taxes due upon the death of the principal.

Again, those scarce dollars could be better employed by plowing them back into the company thereby enabling it to grow and expand and remain competitive.

Everyone agrees that we have to get our country back on its feet economically. The only question is what is the prescription needed to restore the patient to good health.

The administration says we need individual tax cuts and depreciation reform. We concur, but we seriously question whether the proposal pending before you is the correct formula because we are convinced small business has not been made a full participating partner in the proposed economy recovery program.

In short, the administration bill does not have adequate balance in that it does not sufficiently emphasize or target the supply side of the equation.

The President's bill gives 78 percent of the tax cut to individuals over a 5-year period and only 22 percent to business, both big and small. We believe the country would be better served if only 50 percent of the bill benefitted individuals and 50 percent went to business.

These ratios are closely in line with the bipartisan bill reported to the Senate Finance Committee last fall, H.R. 5829. That bill allocated 51 percent of the tax relief to individuals and 49 percent to the business community.

Further, we believe a strong case can be made that small business should receive 50 percent of the business tax cuts. That objective is both reasonable and feasible, particularly in view of the fact that small business is the principal new job generator in the country.

How can this be done? The committee merely needs to ratify those provisions it agreed to last year. Namely, one, expand and further graduate the corporate income tax brackets to a $200,000 level, reduce capital gains taxes by increasing the exclusion to 70 or 75 percent, increase the used equipment investment tax credit to $250,000, authorize employee incentive stock options, increase the accumulated earnings ceiling to $250,000, increase the number of Subchapter S shareholders to 25 and authorize the broker-dealer statutory loss reserve which, as an aside, I should mention all of those provisions are in S. 360.

The corporate graduation provision is the only item on that list causing an appreciable revenue loss. Capital gains reduction is a revenue raiser as demonstrated by the 78 capital gains reduction.

The other five provisions represent a diminimous loss or in the case of the incentive stock option, a revenue gain.

To make the package complete, we would urge that an estate and gift tax reform provision be included as well as a capital gain roll-over provision that would allow for deferred payment of the capital proceeds if they are reinvested in a small business concern within 18 months.

Mr. Chairman, the provisions I have just outlined, describe S. 1140, the Small Business Tax Reduction Act of 1981 which was recently introduced by Senators Bentsen, Danforth, Chafee, Baucus, Boren and Mitchell which is really a refined, narrowed down S. 360 which establishes the small business priorities.

Small Business United strongly believes that S. 1140 is just what the doctor ordered. It addresses capital formation, capital retention and continuity, all three of which are a key to the revitalization of the small business community and in turn, the country.

In summary, we urge the committee to scale down the individual tax cuts, make the depreciation more neutral and include the S. 1140 provisions in the reported bill. For good measure, we would also encourage the adoption of the 25 percent R. & D. tax credit and the $25,000 direct expensing provision, both of which the committee agreed to last year.

Thank you, Mr. Chairman.

Senator DURENBERGER. Thank you, Mr. Neece.

Before we ask some general questions, let me ask you about your figures on 78–22. I assume there is some Mom and Pop in that 78 percent, isn't there?

Mr. NEECE. There is, Mr. Chairman. The best we can estimate and these are numbers that have been generated over on the House side, approximately 5 percent of the individual tax cut measure would flow to sole proprietors, subchapter S and partnerships. In computing the 50 percent figure that would go to small business, the 5-percent factor of the individual Kemp-Roth measure is included.

Senator DURENBERGER. If the chairman of the committee were here, I think he would start out with a question relative to what is wrong with the phase one proposal of the President and I have heard some reaction. This statistic is a reaction to the imbalance.

Mike, I think you indicated basic support for the phase one package including 10–5–3. I know you don't disagree with all the recommendations that have been made here because you supported them in last year's bill.

The question I am sure the chairman would have is how would you intend that we accomplish all of this within the basic financial and I suppose to a degree, physical parameters, that we have to deal with this year. How do we get 10-10-10, 10-5-3, plus some graduation in the rates, estate tax reform, cash accounting, capital gains roll-over which you didn't mention, but I know you all support in one form or another, the R. & D. investments? What is your advice to us other than we ought to pass them all and bet on supply side economics?

Mr. McKEVITT. Well, I would say that would be very difficult. We support a broad potpourri of tax relief measures based on our survey No. 1, Senator and No. 2 is that in the event that the committee were to decide not to follow the phase one recommendations of the President, that you have some alternatives to consider for small business.

Where we are coming from is, we would want to see the deficit and the tax cuts within a close resemblance of each other. We are deeply concerned about any sort of inflationary impact on interest rates which as Mr. Barth so graphically pointed out, and it is true for most of our half million members. It is a very difficult time for them right now. A lot of them are just hanging on.

So, from our aspect, our basic concern is to be careful. Too much of a deficit could have a disastrous impact and might negate any beneficial impact of the tax cuts, keep that in mind as you proceed.

This isn't a shopping list, as much as an idea list to show where our members are coming from and what their needs are. We did want to point out one point, though, that one single cut by itself doesn't do it. We do feel individual cuts will have a great benefit. It has universal application on small business whether it is incorporated or unincorporated so far as that is concerned.

It is like estate taxes and works just like depreciation reform would and like payroll taxes would but we are ever mindful of that and are not in a panacea here or expecting you to pass all of it. I hope I have set up what my feelings are. If you want me to respond further, I would be glad to.

In response to your question, though so far as the administration, our members support both very strongly.

Senator DURENBERGER. Any other comments on phase one plus the recommendations that we had?

Mr. BARTH. Well, I would assume that the effect of 10-5-3, which is the simplified cost recovery system, could be watered down. It certainly, with adjustments, amendments to years, could be made less expensive. I think that is the thrust of your question. We certainly stand for fiscal accountability and fiscal responsibility.

We recognize the need for simplified depreciation and for some acceleration, but there is also the need for the other ingredients and the only way we can have a balanced program is by moderation on point one.

Senator DURENBERGER. Well, it seems to me that from your standpoint you represent America. I mean you can't find a better cross-section of the country than you can find in small business, and if we are going to try to do as much as possible for as many people as possible, you are the people who can best find what that is.

What I hear is that rate reduction in some fashion, will help everybody all the way across the board and so our choices are either taking the Roth-Kemp 10-10-10—or what I hear in the months now that I have been running 360 around the State of Minnesota—what I hear is permanency and dependability in the tax cutting process or the rate reduction process.

People just don't believe, if it is a 1-year cut or a 2-year cut or a 3-year cut, that it is going to last. I have yet to find the person that buys that.

Mr. McKEVITT. That will last, Senator?

Senator DURENBERGER. That will last, right. That it really means this Government has turned around. That there is a change in the way we are going to help the people of this country address the needs of this country. And that is how, simply, I think the people that you and I both represent look at this whole business of tax reform.

It is for that reason and because we have tried it in Minnesota and it works beautifully and painfully, that I am such a strong supporter of tax indexing. I don't buy the argument that to index the income side causes inflation.

I think probably it used to help fight inflation when we were only talking about 1-percent increase was inflation. Now, when we are used to thinking about 8, 10 and 12 and numbers like that, I just cannot believe that an unindexed progressive income tax is much of a commitment to fighting inflation.

But, what indexing in some form has is a sense of permanency to it. We will have the fear that if we do it, we might not balance the budget and you'll go to Minnesota and you'll find a $500 million shortfall and you'll go to some of the other indexing States and you will find problems. The problems come, principally, from the fact that we have not done what those States have done here.

We haven't made resources available to those States so that Governors would have the guts to say yes, I will increase the income tax or the sales tax because we can deliver that service back here a lot better and a lot cheaper.

But, some form of permanency in rate reduction, particularly addressing the issue of marginal rate reduction, seems to me fits within the President's parameters and it goes across the board and it touches an awful lot of people.

When you get to 10-5-3, I am clearly getting mixed signals from this group and again, from my own knowledge from spending a lot of time running around the State just listening to people react to 360. The question I get is why don't you have 10 as well as 5-3? When I explain why they say well that is the same advice I would have given you if I were in your same shoes.

Mr. McKEVITT. Can I comment on that, Senator?

Senator DURENBERGER. Yes.

Mr. McKEVITT. When we had a discussion with the staff of the Small Business Committee, including members of your staff, 10 was not put in there not because it was omitted purposely. It was the idea that because there was some diversified opinion within the groups around the table meeting with the staff of the minority and the majority on the Senate Small Business Committee, it wasn't that they didn't support 10. Most of the groups there, as I recall,

did support the 10. But, with respect to one group, we said let's at least agree on the 5 and the 3 and we will hash the 10 out later.

Senator DURENBERGER. Yes, but as I recall the—it is very difficult to put the 10 part of 10-5-3 in the same ballpark with rate reduction and 10-5-3.

In other words, does it do the same thing that helps everybody all the way across the board in somewhat of an equal fashion?

Yesterday, we heard from a lot of major industries in this country, the infrastructural industries, that it would do very little for them. It could do something for them, of course, but it would do very little.

I know there are a lot of small businesses who would find themselves in the same situation. So, it just seems to me that the leadership that is meeting will probably find some compromise, but I doubt very much whether it is going to be at 10 years.

Mr. MCKEVITT. Can I comment on that?

Senator DURENBERGER. Yes, please.

Mr. MCKEVITT. Approximately 50 percent of our membership and I think it would apply to small business in general are owner-occupiers.

It is obviously going to be a benefit to them and it is going to be an incentive to those who aren't owner-occupiers to build their own buildings. You see now, development of condominium office buildings, warehouses and the like.

There is a concern, particularly by groups like the National Association of Realtors, that it is going to encourage businesses small in nature to build more office buildings, condominium style, warehouses and their own shops and they are right.

We want to do just that and we want to get the Sam Hill out of these leases in suburban shopping centers where we are told what kind of signs we have to put up and hours and getting kicked up every year with increases. Yes, we want to break out of that syndrome. So 10 in that aspect could be very beneficial for small, independent businesses.

Senator DURENBERGER. Well, then, let me ask Mr. Barth to respond to it. I think the concern gets to be the one that he expressed in terms of how do you get into business to begin with so that you can generate enough earnings so that you then have some depreciation available to hold down your tax liability. That is the whole issue of expanding the capital market without using our Japanese printing presses.

That gets us over into the issues of capital formation. I think Jack Danforth here one day raised the issue with some of our economists about the elimination of the capital gains tax and the tax on unearned income and what would happen to the economy.

While they hadn't had time to think that one out because nobody had ever thought of it before, the first reaction was much like yours. The home building industry would take off and the construction industry would take off and the automobile industry would take off and all these great things would happen to the economy. But, that cost $51 billion out of the effort to balance the budget and we haven't done anything for personal rate reduction, corporate rate reduction, and accelerated depreciation.

So, on the issue of the greater availability of private capital versus, using earnings, using earned income as the capital investment, what is your advice, Mr. Barth, as to where we put the emphasis or how can we do some of each?

Mr. BARTH. Well, as I had indicated, there are relatively few recommendations which are specifically aimed to bringing more capital into small business.

I think the capital gain rollover works in that direction.

Another is the proposal for an investment tax credit. That is very limited, however As I recall, a $1,000 credit per person for a $10,000 investment.

It doesn't seem to me that is catching very big dollars.

We have been very supportive of the small business participating debenture, which is a vehicle for encouraging people to invest in small businesses.

Then, I would go further and say that we presently have a situation surfacing which I think belongs in this discussion. That is, as you know, the concern we had about the new rules on the relationship of debt to equity. I think that action has now been deferred until December 31.

But, nevertheless, the purpose of it is to encourage people to make, or business owner-operators to make their investment in terms of capital rather than debt.

If your relationship of debt, both inside and outside, is out of balance with your capital account, then you are in trouble.

Now, at the same time, let's take the situation of the small businessman whose company needs new capital. So, being the good boy that he is, totally aware of the new section 385 rules, he goes to the bank and borrows money that he then invests in equity in his small business. He has investment interest to pay to the bank. There is a limitation of $10,000 of investment interest allowable for an individual.

At 20-percent interest rates, that permits him to borrow only $50,000. So, he has a problem. If he is trying to help a business and he helps it by debt, he has one problem. If he helps it by equity, he has another problem.

He is really boxed in. I think that is going to continue to surface as a disincentive for investing in small businesses.

Senator DURENBERGER. Thank you.

Mr. NEECE. It has been kicking around down there in Treasury for a year, and somebody ought to stomp on it.

That has all the potential of being an unmitigated disaster if that rule is adopted in its current form. It has been postponed to the end of the year.

Senator DURENBERGER. We intend to stomp on unmitigated disasters.

Mr. NEECE. For small business, any way.

Senator DURENBERGER. Allen, let me ask you, is your list of recommendations on page two of your testimony prioritized?

Mr. NEECE. We have tried to avoid being boxed in to establishing priorities.

Senator DURENBERGER. You can continue to avoid that, if you want.

Mr. NEECE. The S. 1140 package has about a $4.3 billion, $4.4 billion price tag for the first full year. If that is put in context, the administration is looking for a gross net revenue loss of $53 billion or $54 billion.

If that package is scaled down to $40 billion, by the Congress, we still think that is a pretty modest package, representing, if you will, 10 percent that is directly targeted to small business.

Again, that is right in line with what the committee has agreed to last year, which was genuinely a bipartisan bill at that time.

There are four items there that essentially cost no money, at least in the context of how the two tax writing committees compute it, and that is the employee incentive stock option, subchapter S, accumulated earnings, and the used equipment ITC.

It is very difficult to even find or measure what those cost.

The two measures in there that do cost you a piece of change would be the corporate graduated provisions and the small business portion of that is relatively inexpensive.

The other one is the estate and gift tax reform.

One way or the other, I suspect there will be some agreement on reducing capital gains, whether it is increasing the exclusion or simply moving down the unearned income brackets from 70 to 50 percent, but it would accomplish the same objectives.

The rollover provision has a price tag of about $700 million in the first year. All of these provisions represent a modest package. We would hate to have it winnowed down any further than that.

Senator DURENBERGER. Let me finish by asking questions on two other subjects.

One is the estate tax. This is one, as I think you know, that I am now putting on practically every bill that is germane. I am doing it because I heard the same things that Mike referred to in his polling. While there may be only 4 percent of the people that died last year that ended up paying a Federal death tax, everybody that goes into business, in any way, or anyone who generates any kind of capital in this country, is making plans for that eventuality. These plans impact adversely on the decisions they make with regard to their money which in effect impacts adversely on the Federal tax take.

I just firmly believe that if the supply side, in effect, arguments were made on behalf of the estate tax, not in terms of what happens at death, but what is happening every single day in the course of judgments made with capital in this country in anticipation of death, that maybe we could get that one somehow forced within the—I am trying to think of a number that goes with 10-10-10-5-3, and it would cost only $4.3 billion out of this 50, whatever it is we are dealing with.

Any help you can be would be much appreciated on that.

Last, on social security, it's my sense, particularly after going down to Tidewater and listening to all of the Republican House Members and Tip O'Neill and all of the Democratic one-minute speeches, that there is some potential that the good that your organizations have recognized in doing something about the problems of the system and the burden that individuals and employers have to pay today in meeting those obligations, may all go out the window for some political sense whether it is timing or whatever.

I don't know—I know you have been at it for a while in NFIB, and looking at reform. I don't know whether you are prepared today to make any general comments by way of recommendation as to what we ought to be looking at in social security reform and in what kind of a timeframe we ought to look at it, or whether you are prepared when Bill Armstrong's subcommittee starts holding hearings, to come up with some recommendations, both on the benefit side, as the President has, and on the financing side.

Mr. McKEVITT. Well, in response to your question, Senator, we are going to elaborate in detail in the coming weeks, what our plan is. We have been working for some period of time with Prof. Michael Boskin, out of Stanford University.

The overall thrust of it is to take—first of all, I think you are scaring people off right now by saying we are going to take early retirement out next year.

I was in Boston, last week, in talking to all three network talk shows. Boy, the people calling in, and then the Washington Post points out, 70 percent of the people now are retiring early at 62.

You can imagine the hue and cry. Hopefully, that hasn't put too much of a roadblock in the momentum of some meaningful reform.

We like to see a proposal take effect in 1990, where you have some adjustment period, where people can plan.

There are too many people right now saying, "Wait a minute. It is unjust." Senator, emotionalism is going to defeat it.

You have to do something though, because you are transferring all these payroll dollars from younger Americans to older Americans. Older Americans are retired or drawing 15 percent. That is money they put in. The others, are drawing, it is money they are drawing from younger Americans in the form of payroll taxes.

We would like to see it divided up. One, when you retire, you have an annuity based on what you pay in.

No. 2, as the other would be, come out of payroll taxes.

I know there are some within the administration, and some within the Senate that would say, "Well, you are talking about general revenue financing." Yes, we are.

Why is it equitable for payroll taxes to subsidize the whole retirement system of this country?

Why is it equitable for people that have to pay this retirement for all different types of people and some of them have gotten by with minimum quarter requirements to do it.

In other words, you get a retirement based on what you pay into an annuity. Other than that, you have a supplemental retirement benefit, patterned after SSI. That would come out of income taxes. That would be more based on a need basis for those who need it as a supplement or need it as a retirement, per se.

Make that in effect 1990, and it is amazing the projections we have done to show you the impact that is going to have on payroll taxes and take a big load off of business in general, particularly small business, which is labor intensive.

Senator DURENBERGER. Any other comments on social security reform?

Mr. BARTH. Yes. I would just like to comment that when you think of all of the burdens that the employer shoulders when he

hires a person, we have gone a great way to provide disincentives for employment.

Until about 2 years ago, we provided tax credits for investments in two areas. One, investing in equipment, and the second, investing in people.

Now, with the exception of a very limited targeted jobs' credit today, we abandoned the investment credit for investing in people.

We do give a credit for investing in equipment, much of which disemploys people, disengages people.

Yet, the small business community, which is providing the massive number of new jobs, is sustaining that cost. Small business is caught in a bind on this, as you can see.

They are not the cause, but they are covering the cost which we think is grossly unfair.

Senator DURENBERGER. Thank you.

Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

I am sorry I wasn't hear to hear your testimony. I had an opportunity to read the written testimony.

Mr. McKevitt, I noticed that you referred to the cash method of accounting. That leads me to ask a question which I would ask a response by all three or a comment by all three of you.

The heart of the President's program, accelerated tax recovery, is, of course, in the area of depreciation.

The Secretary of Treasury appeared before us last week. He conceded the reasons for accelerated depreciation to be that inadequate depreciation procedures result in overstated income, and therefore taxes, and second, that the current system is burdensome, that it is so complicated and so highly regulated, that it makes it very difficult for all persons subject to the law.

I have seen reports of some studies that indicate that the same is true, even more so, in fact, with respect to inventory accounting procedures. That is, that inadequate inventory accounting results in an overstatement of income for American business even greater than that which results in inadequate depreciation procedures.

Of course, particularly with respect to small business, the situation is extremely complex, particularly with respect to the availability of the last in, first out method of accounting.

I have introduced legislation which would seek to address those problems. I would ask each of you to comment on whether or not you agree it is a serious problem for small, business, whether it is desirable from the standpoint of small business to make available cash accounting and to simplify the regulations so that alternative methods of inventory accounting, such as last in, first out, can be available to small business in a meaningful and realistic way.

Mr. MCKEVITT. Well, Senator, to respond, indeed, you have agreed to sponsor a bill or have sponsored a bill in this regard, and our compliments to you and Senator Durenberger, our thanks to you as well, for putting it in the omnibus bill, last year.

It would be a great shot in the arm to business, Senator, for many reasons.

One of the factors, if you look at the two main reasons for audits in this country, for small business, one deals with inventory methods, and the other one is accounting methods.

If farmers can do it, and doctors and lawyers, why can't the other businesses in this country who have inventories use it as well.

You very aptly state that LIFO, last in, first out, for example, is a very difficult formula to work with. In fact, if you ask computer people on it, they will say it is very difficult to even computerize the LIFO system.

Then you have accrual and you have FIFO and you talk to most small businesses and they will say you also have FIST, first in, still there.

So, that is a difficulty as well.

I can't tell you how much of a shot in the arm it would be to small business, to see your legislation come to fruition. It would simplify it for small business. That is what we need, like 10–5–3 in depreciation. What we are pushing that for is simplification, to get rid of ADR and useful life. Because, 98 percent of our members, ask them the next time you are home, either one of you or all three of you, in your audiences, "How many of them use ADR useful life." There is always one or two hands, and usually they are accountants who use ADR useful life. The rest of them don't. All just use just straight old 10-year.

Steve, I am sure you bumped into that in your businesses back in Idaho on this situation. We are saying to you, let's get rid of it and simplify depreciation.

The same is true for cash accounting, as well.

Our thanks to you all for your interest in this.

Mr. BARTH. I would certainly agree that LIFO is a great burden at the moment, for many small businesses. It provides a great deal of business for me and my company, because most small businesses look to their accountants to come in and perform this task, which is somewhat clerical I admit.

It is not at all uncommon for a relatively small company to pay $2,000 or $3,000, in fees, for us to get them a number.

Once they get a number it is by no means a sacred number.

LIFO, in its present state can be manipulated to your advantage or disadvantage, depending upon how heavy you want to buy in the month of December.

If it looks like you would like to bypass a little profit, well, let's go buy some goods. Now that is a silly, silly result.

I have only one concern about the cash basis and that is, if the inventory is a significant asset or the receivables are very significant to the company, I am concerned that for many companies, cash will soon become the generally accepted method of keeping books.

They do run the risk that, unless they keep an eye on what they have in stock, what is owed them and what they owe others, they can go down the drain very quickly without knowing it.

So, maybe it is like many other good things, it does have a danger that attaches to it, that they will come to rely totally on the cash basis results.

I only throw that out, maybe it is because of my accounting background or being a purist, but small businessmen often take the easy way out.

If that is the easy way out, it may be dangerous to them and they should not know it.

Mr. McKEVITT. Could I ask the witness a question, Mr. Chairman?

Senator MITCHELL. Well, let me just comment. The solution to every human problem it seems, within it are the seeds of new problems.

The question is, Are we creating a new problem, greater than the old problem.

I guess that is what I would like to ask you, Mr. McKevitt.

Mr. McKEVITT. I don't think we are. I think what we are doing, first of all, we are going to legalize what some people are doing already. Probably a goodly portion of businesses with inventories are using cash accounting.

It is amazing when you talk to groups, ask them next time when you are back home, any of your groups and say: "How many of you are using cash or accrual accounting?"

They will come up there with $100 or $200 suits on and say, "What is accrual accounting?" They always want to ask you after the speech or after your discussion with them.

So, what you are doing is, in other words, you are getting into something that they are already doing.

No. 2, Mr. Barth raises a good point there. You are going to have to track it from a management aspect. With all due respect, I think it is also, if you are wise, you are going to have accounting for your inventory, but you are going to have management accounting as well.

I think any good accountant should counsel his client that you have to have management accounting and inventory accounting, too.

Senator DURENBERGER. Allen, do you have a response?

Mr. NEECE. Yes, I do.

Senator Mitchell, your question was: "Is it a problem?" and two, "Is your bill desirable?" The answer to both questions is "yes." We are fully supportive of the measure you have introduced.

Our only reservation is, when you put together, that you have to look at the bottom line: What is the price tag for each one of those proposals.

We feel very strongly that both the LIFO problem and the cash accounting are desirable goals. The one that troubles us, however, is the cash accounting portion, because it has been represented to have about a $4 billion price tag.

Now, S. 1140, which you have also cosponsored has a total price tag of about $4.3 billion, $4.4 billion.

So, the question is, can you afford $8 billion or $9 billion targeted exclusively to the small business. There have to be some trade offs.

If you can accommodate cash accounting, great. We are fully in favor of it.

Senator DURENBERGER. Thank you.

Senator Symms.

Senator SYMMS. Thank you very much, Senator. I won't belabor the committee. I am sorry I missed your testimony, but I will—all three of you, go through it, and I appreciate your taking the time to be down here.

I was informed two of you aren't in favor, totally, of the administration's tax bill; is that right?

Mr. NEECE. That's correct.

Mr. BARTH. Yes.

Senator SYMMS. But, Mike McKevitt is.

You are objecting to the marginal rate reduction and saying that you prefer to have targeted tax cuts?

Mr. NEECE. Well, I want to make certain we are communicating here. We are fully supportive of individual tax cuts and we think there is an acute need for a capital cost recovery bill.

All we are quibbling with is, is there sufficient balance in the context of small business needs. Those two provisions, by themselves, will not provide sufficient stimulus for small business to be a full participating partner in the President's economic recovery package.

Senator SYMMS. But you do favor the marginal rate reduction bill?

Mr. NEECE. Yes, but not in the context of 10-10-10, if that is the thrust of your question.

Senator SYMMS. That is the thrust of the question.

Mr. NEECE. Yes, we think it is too rich.

Senator SYMMS. Mike, you do favor it?

Mr. MCKEVITT. We polled our members, I mentioned earlier, before you came, Senator. We polled our members on about 12 different issues, some of which we didn't mention in our testimony.

The one that came up first, now it didn't come out as a distinct majority, it didn't come out high in our survey, was the individual rate. It was polled on the basis of 10-10-10.

Senator SYMMS. Did you want to comment?

Mr. BARTH. I did not comment and do not care to comment on 10-10-10.

Senator SYMMS. Are you for it or against it?

Mr. BARTH. Personally, against it. I think it is too rich for our blood.

Senator SYMMS. In other words, you prefer to have targeted tax relief?

Mr. BARTH. When I gave my testimony, I spoke of the dire problem that small business is finding itself in because of the lack of available capital, the cost of interest being exhorbitant and projected to continue to go up through 1985.

Small business cannot survive that long. If any proposal would possibly push interest rates higher, I would feel that would be very detrimental to small business.

If we have tax cuts that we can't afford, if they precipitate greater deficits, if that means more Government borrowing and less cash available for small business, I can assure you there will be less small businesses available to take advantage of it.

Senator SYMMS. Well, would you favor that this committee go in and make some more drastic or more severe reductions in the outflow of funds say, in the area such as social security or federal retirement benefits, to stop this hemorrhaging of Federal dollars that is pouring out here on the streets that is causing all the problem.

Do you think we should cut spending more, in other words?

Mr. BARTH. I am not quite sure where you are going to cut it.

Senator SYMMS. Well, if we would go after—readjust the COLA's, for example, billions could be saved. I would have to tend to agree that I have been saying all along we are not cutting deep enough, otherwise these interest rates would—the signal to the markets would be that interest rates would start coming down.

So, obviously, even though there has been a lot of hue and cry out around the country, that we were making some adjustments on spending, and I think we are going in the right direction, we are really not making any cuts at all in comparison to what the Congress and President Eisenhower did back in the 1950's.

He actually had a budget that went through Congress one year that was 10 percent less than it was the year before.

We would have to cut another $100 billion out of our budget this year to get that kind of a cut.

Mr. BARTH. Senator, all I was pointing out is that the study made of the Reagan economic program and the United States business sector by Data Resources indicate increasing interest rates which point to the area of 25 to 26 percent for small companies by 1985.

I don't think we can survive 25 and 26 percent interest rates. That is what worries me.

Senator SYMMS. Well, I would have to agree with you. I know we have—we can't survive 25 percent interest rates. There is no question about that.

There is certainly no question about it that we have problems with our thrift institutions that are a big portion which will have a spill over effect on small business, and business in general.

But, I do think there is some merit to be said for passing the President's program as soon as possible, just to give a vote of confidence to the general producer side of the economy, that we are not going to have the Government continue to try to hold their heads under water in the future. Help them get up on the bank, at least. The way it has been in the past, to keep pushing them down in the swamps with the alligators.

Some of them would like to get up on the dry ground for a chance, and hopefully, we could do that.

I thank you very much.

Thank you, Mr. Chairman.

Senator DURENBERGER. Thank you very much.

Any other comments?

[No response.]

Senator DURENBERGER. Thank you very much.

Mr. MCKEVITT. One comment.

Senator DURENBERGER. Yes.

Mr. MCKEVITT. The comment earlier about cash accounting costing $4 billion. We were advised just yesterday that that has been revised. It was revised by Senate staff members of the Senate Small Business Committee. The joint tax committee, currently is estimating revenue loss at less than $1 billion. It is around $990 million, approximately.

Senator DURENBERGER. Thank you very much.

[Statements follow:]

Prepared Statement of James D. "Mike" McKevitt

SUMMARY

NFIB's membership reflects the entire small business community. We have "Moms and Pops" and sophisticated high growth firms. We have capital intensive and labor intensive firms. We have new firms and mature firms. We have proprietorships, partnerships, Sub-chapter S corporations and corporations. They are in every city of every State in the country. You name it, and if it's a small business we've got it. And from this diverse group we have learned one thing—no single tax change is a "small business" cut. It may be a small retailer cut or a small corporation cut but not a small business cut. Only a package can achieve that such as: Marginal rate cuts, payroll taxes, Depreciation reform, The cash method of accounting, Further graduation of Corporate taxes, Estate tax reform, and Savings incentives.

STATEMENT

Mr. Chairman, on behalf of the National Federation of Independent Business (NFIB) and it over one-half million small and independent member firms, I appreciate the opportunity to present our views on the Administration's tax reduction proposals.

Since the commencement of the NFIB Quarterly Economic Report for Small Business in 1973, our members have consistently indicated to us that inflation is the single greatest threat to their existence. The inability of small firms to fully pass on rapidly rising material and labor cost respresents the greatest threat to small firms, since their retained earnings are increasingly squeezed. As the cash flow of these firms is diminished, small firms are forced to seek external sources of operating capital to stay in business. Stepped up borrowing for daily business obligations has the deterimental side effect of reducing the ability of small firms to borrow for investment purposes. Over time, such a change in borrowing patterns would lead to a secular decline in the productivity gains among small businesses. This inflation-induced "survival" borrowing is a much more expensive manner in which to finance daily operations. This in turn further erodes profits and diminishes the ability of small firms to generate internal sources of funds. As is clearly seen in Illustration 1, the percentage of small firms which need to borrow regularly varies directly with the rate of inflation.

To make matters worse, prolonged periods of inflation have the added effect of raising the tax liability of small firms. Due to the complexity and associated costs of accounting methods designed to help offset the effects of inflation, most small firms pay disproportionately high taxes. This, again, represents another drain on the retained earnings of the average small business.

Thus, actions taken to attain a permanent and significant reduction in the rate of inflation would in the long run benefit small business more than any other policy action. However, after a decade of high and volatile inflation, it is likely that the restoration of price stability will be a long and difficult process. Throughout that process, thousands of small firms could go bankrupt unless some immediate measures are taken to allow businesses to more easily generate operating capital through internal means. The obvious manner in which to obtain such relief is through business tax cuts. Although we feel that reduced business taxes stand on their own merit, current and expected economic conditions dictate tax relief measures. Otherwise profit margins will continue to erode as the price level grows near double-digit levels as expected, and as labor costs continue to rise due in part to the recent increase in the minimum wage and in the social security payroll tax.

The critical need for business tax cuts is self-evident. We at NFIB feel it imperative that the total size of a tax cut package be limited to the equivalent size of pending government spending cuts. The remainder of our statement will address the specific tax policy actions that we feel will be the most beneficial to the small business community.

NFIB tax cut priorities

Defining small business legislatively is a Herculean task that many have attempted. There are approximately 13 million business entities, including corporations, partnerships, and sole proprietorships. A common request from Congress is for the "one" tax proposal that would benefit all small business. It is patently impossible to propose one such solution, given the breadth and variations that comprise small business.

However, contrary to what you may hear from some, the tax code does discriminate against small business. The effect of this discrimination results in concentra-

tion of business because small firms can benefit more by selling to large firms instead of to small entrepreneurs. The discrimination also inflates small business profits causing overtaxation because smaller firms are unable to take advantage of a highly complex tax law.

Tax policy and tax reforms are essential to aid small business growth. However, these actions need to be considered within the context of the damage that high inflation and high interest rates have caused. The largest tax increases over the last twenty years resulted from inflation and bracket creep, not Congressional mandate.

Larger firms can take advantage of prior retained earnings or have the choice of equity funding and borrowing to handle short-term cash problems. Small businesses, because of a prolonged period of inflation and high interest rates and taxes, are drained of retained earnings and are being denied equity and access to borrowed funds because the necessary rates of return to investors or lenders are too high.

NFIB's membership reflects the entire small business community.[1] We have "Moms and Pops" and sophisticated high growth firms. We have capital intensive and labor intensive firms. We have new firms and mature firms. We have proprietorships, partnerships, Sub-chapter S corporations and corporations. They are in every city of every State in the country. You name it, and if it's a small business we've got it. And from this diverse group we have learned one thing—no single tax change is a "small business" cut. It may be a small retailer cut or a small corporation cut but not a small business cut. Only a package can achieve that.

Marginal rate cuts.—Reduction of individual taxes by reductions of marginal tax rates is a proposal that will benefit many small businesses. Tax relief for many of the smaller unincorporated businesses can only be achieved by basic tax reductions.

Over the last ten years, bracket creep caused by inflation has eaten away at the profits of these small businesses, severely impeding their growth and often contributing to failure of the firm.

Individual rate cuts is a very high priority for a majority of the business community and should be an integral component of any tax package.

Payroll taxes.—Small business generally represents the labor intensive segment of the economy. Over the last decade, most of the growth in employment has occured among smaller firms. Meanwhile, the nominal cost of the employer's portion of social security taxes has doubled since 1975 and will double again by 1986 on any employee at the wage base. This increase in the cost of labor has had its expected result, i.e., higher unemployment rates and lower employment expectations among small business.

The higher rates of Social Security contributions were mandated by Congress to forestall a cash shortage in the Social Security program. A similar problem is now expected to occur during 1982. Obviously, the Social Security system has structural difficulties that need to be addressed by Congress. As a part of a tax package, small business needs payroll tax relief as part of any solution to stabilize the cost of running the Social Security programs.

Depreciation reform.—Simplification of depreciation for small business is a leftover concern of the 95th Congress. Since 1978 inflation has removed the useful life concept further from reality. Depreciation deductions are not even close to what they should be, a problem that has hampered small business for years.

The major problem for small business with the depreciation rules is that large firms, using sophisticated tax techniques and costly tax advisors, receive greater depreciation deductions than small business when buying the same asset. The major stake small business has in depreciation reform is to have a usable set of rules that small firms can use as easily as larger firms. In this context, any depreciation reform proposal that begins with the Asset Depreciation Range (ADR) rules is unacceptable to small business. Available statistics from the IRS reveals that less than 3 percent of all corporations with under $1 million dollars in asset size use ADR, illustrating why ADR needs to be eliminated.

NFIB strongly endorses H.R. 1053 as the viable solution for depreciation. H.R. 1053 will allow small business to use accelerated depreciation rules on a scale never before available. Additionally the "10-5-3" system will assist the more capital intensive firms by providing both a faster return on investments and reduced taxes which will lower financing costs, another major small business concern.

"10-5-3" was designed to be of assistance to productive operating businesses. Much of the recent concern and debate has come from that part of the community least affected by depreciable lives. Congress needs to be aware that small businesses

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[1] Construction, 14 percent; manufacturing, 11 percent; transportation, 2 percent; wholesale, 8 percent; retail, 31 percent; agriculture, 4 percent; financial services, 10 percent; Nonprofessional service, 10 percent; professional services, 10 percent. *NFIB Quarterly Economic Report for Small Business*, October 1980.

generally are less mobile and turn over capital assets only when the assets become economically unproductive. Tax concerns are not the major reason for an operating manufacturer or retailer to dispose of assets.

Other proposals for depreciation reform are garnering support as alternatives to "10-5-3" and in fact, as they are maturing, are moving closer to "10-5-3," in impact and effect. Naturally the question presents itself, instead of trying to come close to "10-5-3" why not accept "10-5-3"?

Clearly the majority of the business community supports depreciation reform. Small business' prime concern is that depreciation reform result in a simple and usable system. Maintaining any vestiges of either ADR or useful life as a concept of depreciation only ensures complications in the tax law.

The administration has proposed a depreciation package very close to "10-5-3" but with important differences of concern to small business.

First, ACRS establishes three real estate categories, two of which are a 10 year owner occupied category and a 15 year non-owner occupied category. The chief concern is that two similar firms may be getting different treatment when depreciating the same asset. The recapture treatment also is vastly different with the 15 year category, providing substantially better recapture treatment.

NFIB's members for the most part rent their facilities, but 44 percent do own their own buildings. The lessons of home ownership are certainly not lost on small business owners. I am sure many would prefer to own their own buildings, but many will continue to lease. Having the depreciation benefits available will perhaps make the decision to own more attractive for some. However, this is a business decision as much as a tax one, and neutrality is hard to define in terms of a relative cost that differs for each firm.

Second, the President's proposal requires use of the allowed and allowable depreciation rule in current use, but the net operating loss rules would be changed to ten years from the current seven years. "10-5-3" allows maximum flexibility of depreciation deductions by allowing an indefinite carryover period. This concept is preferable because it removes the possibility that carryforward benefits might be lost. For unincorporated firms an unlimited carryover is preferable because net operating loss benefits may be lost when the individual's tax information is added to the business tax information to determine the annual loss.

Finally, a more flexible placed in service rule is envisioned under "10-5-3" that would allow a firm to utilize depreciation deduction and any investment tax credits when costs are paid, not when placed in service. This change affects the return on the investment by allowing deductions in an earlier taxable period.

A substantial part of the business community is supporting the "10-5-3" concept. Congress is left to decide the final form of the depreciation proposal, but should take into account the overriding need and concern of small business for simplicity and utilization in depreciation reform.

The cash method of accounting.—For small retailers, wholesalers, and manufacturers, the overvaluation of ending inventory causes overtaxation of profits. This overtaxation takes place because of inflation and the effect of price increases on inventory purchased for resale.

To facilitate understanding of the small business accounting and inventory methods problem, a simplified illustration of a small retailer is presented below.

Company X sells tables to the public. In 1980, Company X bought 800 tables at a cost of $50 a table. Each table sells for $100, and by the end of the year 700 tables were sold. How is profit before taxes determined?

Income Statement of Company X For Period January 1, 1980–December 31, 1980

The cash method:	
Revenues from sales (700 tables: $100 a table)	$70,000
Cost of goods sold (800 tables: $50 a table)	40,000
Gross profit	30,000
The accrual method:	
Revenues from sales (700 tables: $100 a table)	70,000
Cost of tables purchased for resale (800 tables: $50 a table)	40,000
Cost of unsold tables as of December 31, 1980 (100 tables: $50 a table)	5,000
Cost of goods sold	35,000
Gross profit	35,000

The hypothetical income statement reveals the obvious effects of using the accrual method, which are: (1) A higher tax rate, essentially on the value of the inventory (inventory tax), due to a higher gross profit; (2) greater borrowing and interest expenses because most small businesses finance inventory through short-term borrowing (20 percent interest rates further exacerbate the problem); and (3) higher accounting fees.

The choice of the accounting method to be used for tax purposes is controlled by IRS regulations. Section 1.471-1 states, "In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor." Retailers, wholesalers and manufacturers are therefore restricted to use of the accrual method for tax purposes.

The differences between the two accounting methods reflects the fact that tax returns and income statements are summaries of a firm's operations for a fixed time period. Cash method only recognizes money flow, actual receipts and paid expenses. The accrual method seeks to match revenues and costs for each item sold.

Various complications occur in real life situations. The biggest complication is inflation. Inflation causes the overvaluation of ending inventories. This occurs because of the methods used both to identify and to value inventories in the context of a tax return.

The identification and valuation of inventories is the basis for a very complex set of regulations. Business concern is justified because inventory numbers can substantially affect a firm's net profit. Returning to the example of an accrual balance sheet, if the cost of unsold tables (ending inventory) is higher, profits are higher. The reverse occurs if ending inventory values are lower.

Common practice and logic dictates that a business sells off inventory in the order it is purchased. This is the basis for the FIFO method (first in first out). FIFO, an allowable inventory method under IRS regulations, causes problems during a period of inflation. Once inventory is purchased and stored, it loses its specific identity. Valuing inventory at the lower of cost or market generally means that current inflated costs are used. Inflation causes current inventory to be more expensive than earlier purchases of inventory.

This overvaluation of inventory under FIFO can be corrected if a business switches to LIFO (last in first out). The effect of LIFO is to use earlier inventory costs to value inventory. The result is a lower ending inventory because the difference between LIFO and FIFO results are deferred. The deferral becomes income when prices go down or the inventory pool is liquidated. LIFO in 1975 was utilized by less than 1 percent of all corporations because of its complexity and implementation costs.

Smaller firms are squeezed and in practiced receive discriminatory treatment under IRS regulations. The cash accounting method for small firms would alleviate their having to deal with inventories, which would reduce taxes, lower professional fees, and reduce carrying costs and borrowing.

In the past, when a taxpayer was found to be in violation of the rules concerning accounting methods, the revenue agent's tax assessment was spread over ten years. This rule recognized that penalizing a firm did no good if the penalty put the business into bankruptcy. IRS has apparently changed its mind. Revenue Procedure 80-51 states that once an examination begins and the business is found to be using an improper accounting method, the firm will have to pay any tax assessments immediately.

Considering the fact that the rules are so complex and the level of accounting sophistication among small business is relatively low, this seems an unnecessarily harsh approach. The committee should consider this an added reason for considering a cash method proposal.

In 1976 Congress allowed farmers to use the cash method of accounting when the firm's gross sales are less than $1 million. The committee report cites one major factor in Congress' decision, that the cash method of accounting is simple to use and understand. The reasoning of Congress was valid for small farmers, therefore why not apply it to all small businesses?

Senator Mitchell has introduced S. 1180, a bill which encompasses many of the recommendations of the Inventory Accounting Task Force sponsored by Congressman Henry Nowak. Included in this bill is a proposal for allowing cash accounting to be used by small business.

The particulars of this bill are worthy of your attention because of the impact inflation has on a firm's ability to replace inventory.

Further graduation of corporate income taxes.—Further reductions and graduation of corporate rates would provide necessary relief to those firms not assisted by other tax proposals. Bracket creep has, since 1978, eliminated the benefits realized in the

1978 corporate rate reductions. Increasing the number of brackets from the current $100,000 level to $250,000 is a practical method to reduce taxes for small corporations, which in many cases have a higher marginal tax rate than some of the largest corporations in America.

The tax rate above $250,000 should not be lowered, but the base rate for taxing the first $25,000 of taxable income should be reduced to 12 percent. A reduction in this fashion would benefit the high percentage of corporations who have taxable income levels of less than $100,000.

Estate tax reform.—The public's general perception is that estate tax laws somehow force the very wealthy few to redistribute enormous amounts of family wealth upon death. We know that the truly wealthy actually redistribute very little family wealth because these wealthy few have sophisticated inter-generational tax planning devices to substantially avoid estate taxes. Table A illustrates that approximately 95 percent of all 1976 estate tax returns filed represented gross estates of $500,000 or less in size.

The estate tax has been affected by inflation and bracket creep in much the same way as the income tax. Inflation has also affected the problem of placing a fair market value on a business and continues to cause great concern because of complex valuation rules that create inflated values. Valuing an ongoing business at a specific point in time is difficult under normal conditions but impossible when the economy fluctuates as it has been doing over the last few years. Often the difficulties result in inflated asset values and substantial estate tax liabilities that can force the liquidation or sale of the business to provide sufficient cash to pay the estate tax bill.

Naturally strategies do exist for minimizing estate taxes, but they create their own distortions. One NFIB member in Virginia owns a lumber mill and is currently using 20 percent of his profits to purchase life insurance to ensure that there will be sufficient cash to satisfy an estate tax liability.

In 1976, $5.3 billion dollars in tax revenue was generated by the estate and gift tax.[2] According to Department of Treasury data, the major number of filers of estate tax returns are the smaller estates. We do not have the data on the distribution of taxes paid by size of the estate. The facts lead to a question that needs to be answered. Is the estate tax necessary? Based on the percentage of small estates filing estate returns, it is probable that substantial financial resources are being spent on tax counsel and life insurance premiums. It might be that when the costs of government administration, tax counsel, and life insurance premiums are compared to the revenue generated, the estate and gift taxes are not cost effective. If this is so can another, less costly way of raising this revenue be found?

Additionally, is current estate tax policy placing too great of an administrative burden on the small business? Since the wealthy minimize their estate taxes, it is possible that a relatively higher burden is being placed on smaller firms.

To summarize, the following are the problems of small business with the estate tax:

(1) Inflated valuation of business assets is causing inflated estate taxes to be paid. The result is that the Treasury Department, through the estate and gift tax provisions of the tax code, subsidizes life insurance companies.

(2) The family owned business is being threatened by high estate taxes and the attractive tax benefits of non-taxable exchanges that encourage the sale of many family owned businesses to larger firms.

(3) The rules which govern the determination of a business' fair market value are in need of revisions.

(4) The rules that allow an estate to spread out any estate tax liability payments need to be liberalized to make this option more readily available to the heirs of a business.

Solutions of various designs have been proposed by members of this comittee. I would counsel you to attempt to attain three policy goals: (1) Overall reductions in estate taxes: (2) simplification of estate tax rules; and (3) certainty of estate tax responsibility.

Savings incentives.—To increase the stock of available capital for investment in this country is imperative. This can best be accomplished by reducing the penalty and bias in the tax law against savings.

Gradual elimination of the taxation of dividends and interest would be a major step towards that goal. Additionally, working people and business owners need help in saving for retirment, but do not need the increased financial burden that a mandatory pension system would impose. Expansion of the Individual Retirement Account (IRA) concept, which would allow employees to establish an IRA even

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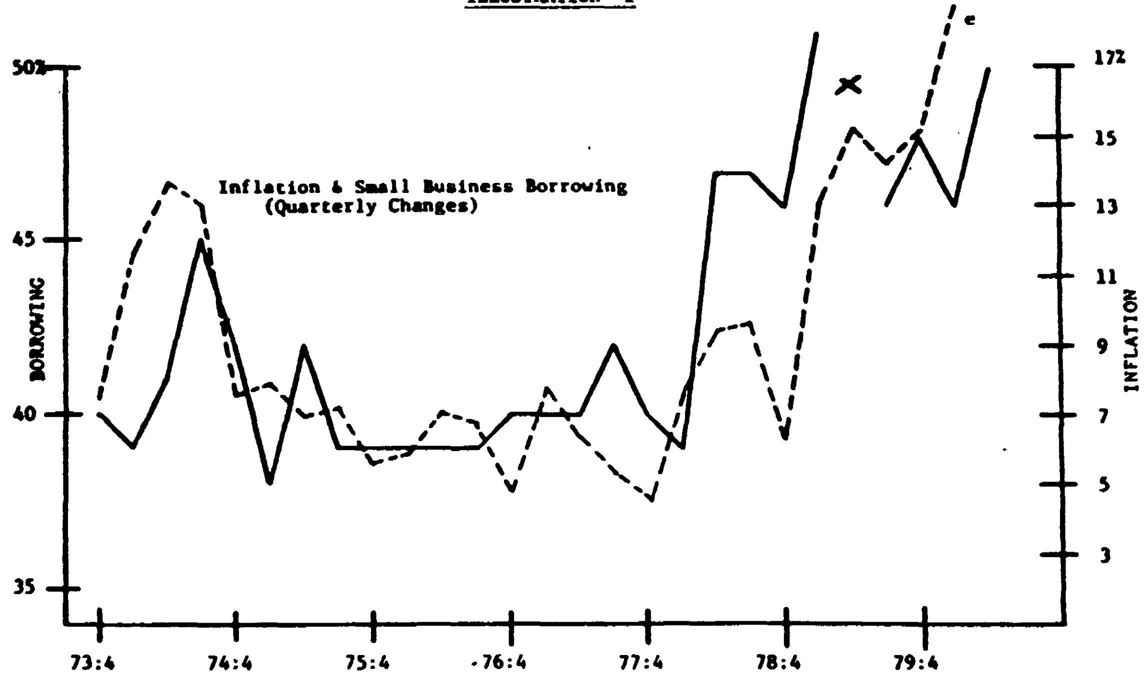
[2] Office of the Secretary of Treasury, Office of the Tax Analysis.

though they may be actively participating in an employer's plan, would be highly beneficial.

CONCLUSION

Our testimony has concerned itself with both tax and economic policy. We can no longer afford the luxury of considering these problems separately. The following points do need to be stressed in your deliberations: (1) Inflation is the nation's greatest threat; (2) monetary policy must be moderately restrictive, and greater efforts must be made to stabilize the growth rates of the monetary aggregates; (3) Federal spending must be continually reduced and tax cuts should be limited in size to spending cuts; (4) small business tax reform must stress short-term capital retention needs and long-term capital formation needs; (5) the ADR method must be eliminated as a basis for depreciation deductions; and (6) Tax reforms must be structured to impact all types of businesses.

ILLUSTRATION 1



---- non-food CPI (annualized rates)
—— % of firms borrowing regularly (defined as borrowing at least once every quarter)
X April, 1979 data not available
e Estimated

Source: NFIB Quarterly Economic Report for Small Business

Outline of Testimony of the Small Business Legislative Council Before the Senate Finance Committee

FINANCE COMMITTEE INITIATIVES SUSTAINED SMALL BUSINESS DURING THE 1970'S

The Small Business Legislative Council commends the Committee for its initiatives in establishing progressive corporate rates, modernizing the estate tax, rolling back capital gains rates, and spearheading depreciation reform.

These developments have been major factors in preserving and encouraging independent enterprise during the difficult 1970's.

BALANCED TAX POLICY NEEDED FOR 1980'S

As we face such major problems as energy shortages, inflation, and high interest rates in the 1980's, it is even more important that federal tax policy take account of the special needs of the nation's 15 million new small and independent businesses.

GENERAL SUGGESTIONS

We welcome President Reagan's initiatives in the budget, tax and monetary areas. The 1981 business tax reductions will probably be the largest in history and their impact will dominate U.S. industry in this decade.

We therefore recommend: Information on the proposed distribution of revenue benefits and costs by industry and size of business should be fully developed; the overall size of the tax cut should leave a cushion for responsible fiscal policy; business tax reductions should constitute about half of the benefits; the reductions should be designed as anti-inflationary whereever possible in such ways as gearing part of personal tax cuts to offset increases in the social security taxes; and an appropriate proportion of the cuts should be targeted to the dynamic small business community which accounts for more than three-quarters of new private sector jobs and half of all industrial innovation.

SPECIFIC SMALL BUSINESS PROPOSALS

An attachment sets forth a sries of "options" that would be most helpful to smaller firms across the spectrum of the economy. Also listed are several "off-sets" that could substantially reduce the cost of the legislation. We strongly support depreciation reform, and believe it can be enacted in a form that will accommodate many of the other excellent provisions approved by the Committee last year as a part of H.R. 5829. Which will make the economic benefits of the bill more widely applicable.

Major small business provisions we support include the following:

Corporate rate reductions, scaled up to $200,000 in two years (as was approved by the Committee in 1980 as a part of H.R. 5829) and at least $250,000 in the "out years;"

Direct expensing of the first $25,000 of annual equipment purchases (as in H.R. 5829, S. 394, and H.R. 3202);

Increase to 25 percent of the rehabilitation credit for 20 year old structures (H.R. 5829 and the Long/Bentsen bills, S. 317 and S. 394);

Increase of the ceiling for used property eligible for the investment credit to $250,000 (Weicker-Nunn and Bentsen bills, S. 360 and S. 1140);

Revision of estate tax limitations and rates to realistic levels permitting continuity of family and closely-held farms and businesses, such as are found in the Wallop-Boren-Bryd bill (S. 395);

A broadened employment credit to take the place of the expiring WIN and targeted jobs credits, which would accord balance in the law for labor intensive small firms;

A limited credit for incremental research and development expenditures, further capital gains reductions in some form and the specialized measures such as are contained in the Long, Bentsen and Weicker bills (S. 394, S. 1140 and S. 360) to spur investment, capital formation and capital retention in innovative new and small ventures;

The beginning of inventory reforms allowing small business to use LIFO accounting systems to better adjust for inflation;

Appropriate incentives for savings, so local financial institutions will be able to compete for funds sufficient to extend credit to independent firms, particularly in the construction industry.

Addition, the Committee should explore proposals for increasing outside investment in small firms such as capital gains roll-over, new issue credit, and the small busienss participating debenture; and it should review regulatory and statutory

provisions discouraging re-investment by entrepreneurs in their own businesses, such as the debt-equity regulations and limitation of deductible investment interest.

We believe that balanced legislation of this kind is within the spirit of the President's program and we would welcome the opportunity of working further with all concerned to advance such legislation.

APPROXIMATE 5-YEAR TOTAL REVENUE EFFECTS OF SMALL BUSINESS OPTIONS TO 1981 TAX BILL (H.R.2400)

(1st Order Revenue Impact in Billions of Dollars*)

Fiscal Years 1981 - 1985

	Option	Five-year total
1.	Corporate rate reductions under $200,000 [would increase modestly if level adjusted for inflation beginning 1983.]	- $7.6 billion
2.	Depreciation: Equipment	
	A. Expensing of $25,000 per year, without 1% investment credit [with 1% ITC - $13.7 billion]	- $8.5
	B. Increase of Used Machinery Investment Credit to $250,000 would require some adjustment for carryover of property	- $1.2
	C. Use of 15 years (for structures) and 10-7-4-2 (for equipment) framework vs. 18-15-10-5-3 -- with 30% of ADR for utilities vs. estimated 50%+ proposal	+ $49.8
	D. Elimination of depreciation and Investment Tax Credit on Progress Payments of property taking more than 2 years to build	+ $6.9
	Structures	
	E. 25% Rehabilitation Credit for 20-year-old structures	- $2.8
	F. Would require adjustment if a spread were adopted for structures of "owner operated" businesses	
3.	Employment Tax Credit -- Broaden from targeted to general in 1982	- $10.0
4.	Small Business Capital Formation -- specialized provisions	
	A. New Issues Credit	- $.076
	Rollover -- out of 1 small business, into another	- $3.4
	Small Business Participating Debenture	- $6.1
	B. Accum. Earnings increase to $250,00, Subchapter S increase to 25 shareholders, Incentive Stock Options, Broker-Dealer Profit Reserve, Remission of diesel excise tax	- $1.3
5.	Credit against income tax for social security increases [If part of individual income tax reductions were measured in this way, small employers and self-employed persons would realize $31.6 billion in tax reductions during this 5-year period.]	zero
6.	Capital Gains Tax Reductions to 20% for individuals and corporations [Contained in present bill; independent cost about $10.7 billion]	zero
7.	Estate Tax Reduction to $600,000 exemption, and related improvements	- $9.8
8.	Inventory reform	
	A. Resolution of Thor, 10 year spread on tax increased in adopting LIFO system, indexing and pooling	?
	B. Cash Accounting at $500,000 of receipts	?
9.	25% Research and Development Credit	- $2.9
10.	Interest exclusion equal to dividend exclusion, tied to mortgage lending	?
11.	Extend Conservation and Solar Energy Credits to rental property	- $.637
12.	Offset: Elimination of 1st year small business depreciation (§179)	+ $1.0

TOTAL OF ALL OPTIONS:	GAIN	$57.7 billion
	LOSS	$54.32 billion
PROVISIONAL NET IMPACT		+ $ 3.38 billion

* Estimates by Small Business Legislative Council from various published sources.
? No existing estimates as of May 18, 1981.

Prepared Statement of William D. Barth on Behalf of the Small Business Legislative Council

Mr. Chairman and members of the committee, my name is William D. Barth. I am Director of Small Business Practice of Arthur Andersen & Co. I am appearing today on behalf of the Small Business Legislative Council (SBLC), an organization of 82 small business and trade associations representing 4½ million U.S. business enterprises nationwide.

We applaud the resolve of the President and Congress to reduce inflation and increase productivity. We highly commend the Reagan Administration for making these its top priorities and for emphasizing the interdependence of budget, tax, and monetary policies in reaching these vital objectives.

We also commend the Senate Finance Committee for its outstanding leadership since 1975 in the tax area. Among its many initiatives have been: Making the corporate income tax progressive up to $100,000 (vs. $25,000 under the pre-1975 law); reforming the estate and gift tax structure for the first time since 1912, is such ways as lifting the estate tax exclusion from $60,000 to $175,000; rolling back capital gains taxes from a maximum of 49 percent to 28 percent and establishing a $100,000 exemption for home sales by the elderly; and spearheading accelerated and simplified depreciation, one small business formulation of which passed the Senate in 1978, with a comprehensive version reported to the Senate in 1980.

These developments have been major factors in sustaining and preserving smaller business during the difficult decade of the 1970s.

BILL SHOULD IMPROVE THE FUNDAMENTALS OF THE ECONOMY

Both the President and Congress seek to improve the basic foundations of our national economy. The fifteen million small business which make up a very important part of that economy are greatly encouraged that both the Executive and Legislative branches are now in virtual agreement on these goals, and that the debate at this juncture is how they may be accomplished.

For many years, advocates of small firms have been saying that "small business is the heart and soul of the economy." Statistics confirm that assertion.

Small firms sustain 55 percent of existing private sector jobs, and create a striking percentage of net new employment.

They create half of all innovation in heavy industry, light industry, trade and commerce. These innovations have sparked impressive advances in employment, exports and tax revenues.

They make major financial contributions to all levels of government. For example, a 1978 survey showed that $100 invested in the electronic industry yielded $35 per year in federal, state, and local taxes.

Small business owners are major factors in the stability of their towns and cities. They know their employees and customers. They are the last to fire when the economy turns down and the first to hire employees as it revives. These owners have a stake in their hometowns, so they and their families work to support churches, charities and other neighborhood and community institutions.

FAIR TREATEMENT FOR SMALL BUSINESS

For the sake of the U.S. economy and society, and for the success of President Reagan and Congress in upgrading our national strength, it is essential that small business be treated fairly.

The five-fold Administration program is comprised of parallel budget and tax cuts, easier government regulation, a controlled slowdown in monetary policy, and a sizable increase in defense spending. The tax part of the package is composed of tax rate reductions for individuals, adding up to $554 billion over 5 years; and $164.3 billion in reductions for businesses over the same period, for a total of $718 billion.

There are two remarkable features of this proposal. The first is size. These are probably the largest tax cuts in history. The second is structure. The individual side contains only rate cuts, and the business side contains only a speed-up in the recovery of capital newly invested in physical assets—plants and equipment.

We feel strongly that before such enormous changes are legislated, their impact on small business and the economy should be thoroughly understood.

Despite the fact that proposals such as H.R. 2400 have been before Congress for about two years, there have been no official studies which disclose how the tax reductions would be distributed among businesses of different sizes.

In the absence of such information, we performed a study of the relative speed-up of depreciation lives under the Administration's bill which showed wide variations by industry. The study is attached as an Exhibit to this testimony.

CONCERNS WHICH HAVE BEEN EXPRESSED

We have noted serious concern expressed about this tax proposal in some of the nation's most prominent newspapers. For example:

The lead story in The Wall Street Journal of March 9 was headlined: "Doubtful Benefit, Fast Depreciation Bills Stir Much Criticism, Even at Needy Firms; Many See Only Slight Gain to Low Profit Concerns that Pay Minimal Taxes. . ."

The category of "Low Profit Concerns" contains many industries that need help, but may be marginally profitable, or even losing money—such as autos, steel, airlines, and perhaps utilities. But this category also contains most new companies, which usually take several years to earn a profit. This class also includes many efficient segments of the economy, where prices are kept down by keen competition, often supplied by many small firms.

The Journal article says that at an 8 percent return on equity, the 10-5-3 plan increases the depreciation deduction by less than 5 percent.

A Washington Post column by William Raspberry on March 2 quotes an economic consultant to the effect that the proposed depreciation benefits will be concentrated on a limited number of very large corporations, as follows: "By all accounts, accelerated depreciation allowances are of greatest use to profitable, capital-intensive firms, principally large, mature companies to be found among the Fortune 500. . .Unfortunately, these are the very companies which grow most slowly and create the fewest jobs. Simply transferring cash to them will certainly not help them grow quickly; mature companies can't. It's like trying to make gazelles out of dinosaurs by feeding them more. What the accelerated depreciation will do for the big companies is to encourage them to buy up smaller ones—which is the only way they grow. That doesn't create new jobs."

This observer suggests some alternatives: "If he [the President] really wants to spur economic growth, he needs to propose incentives to spur the growth of young expanding firms. Reductions in capital gains tax (with a differential for distressed areas) and other measures to encourage risk-taking and entrepreneurship would make for more sense in this regard than rapid-depreciation allowances."

A New York Times editorial of March 9 entitled "The Better Way to Cut Business Taxes" questions whether the 10-5-3 depreciation proposal might emphasize short-term results over longer-term productivity. It then recommends the "present value" depreciation, which would constitute a proportional reduction for all industries, and could be taken all in one year. Fortune magazine of the same date also comments favorably on this concept.

The observation about the concentration of capital recovery benefits under present law is confirmed by our own SBLC 1979 study, which indicated that the largest 2,015 companies (roughly equal to the number of corporations listed on the New York Stock Exchange) already absorb about 55 percent of the investment tax credit, and about 45 percent of existing depreciation deductions.

Several nationally known economists, some with unchallenged conservative credentials, have also counselled caution:

Arthur Burns, in March, told participants in an American Press Institute program: "Plans now in effect to reduce federal deficits gradually and to cut money supply expansion by less than one percent a year 'could easily be swamped by external developments . . .'"

Walter Heller, former Chairman of the Council of Economic Advisors, made a similar point on NBC's "Meet the Press" broadcast, observing that the only way 10 or 11 percent growth in the GNP could be achieved under the tight money policy envisioned by the Administration would be to have a turn-over rate for money that is far beyond historical experience. He also noted that the 1964 tax cuts to which the present proposal is often compared, came at a time when inflation was only one-tenth of what it is now (1.2 percent versus 12 percent) and there was three times as much slack in the economy.

Eliot Janeway, testifying before the Senate Small Business Committee on March 9, also called attention to high inflation and interest rates as an unfavorable backdrop for a large tax cut coupled with a large defense build-up, which would put a lot of money into circulation but would not produce anything consumers or businesses can buy with this money.

Rudolph G. Penner, of the American Enterprise Institute, writing in the New York Times on February 22, 1981, noted: "The Administration's economic assumptions are particularly worrisome because there is an apparent inconsistency between the government's fiscal plan and its monetary plan (e.g.) . . . the Administration's dual assumptions of rising growth rates of nominal GNP and slower growth rates of monetary aggregates."

Herbert Stein quantified these factors in the April, 1981 issue of The Economist letter of the American Enterprise Institute, as follows: "[The projected rise in

current dollar GNP of 11.7 percent] a year for the next six years (a little faster than [11.2 percent] in the previous six years) . . . is to be achieved with a growth in the money supply that is about one-third less than in the previous period. [This is] inconsistent with past experience."

Richard F. Janssen in the Wall Street Journal "Outlook" column of March 9 entitled: "Expectations Policy Stirs Concerns" quoted Lawrence Chimerine of Chase Economics this way: "The new program may not reduce inflationary expectations at all . . . large tax cuts, budget deficits, and substantial increases in national defense have historically been associated with accelerating inflation."

IMPLICATIONS OF PROPOSALS SHOULD BE EVALUATED

We are not economists, and are not offering any comprehensive prescription. But there is a point we wish to make—before a final commitment is made to any tax cut of this magnitude, the evidence already on the record suggests that the consequences of this tax depreciation proposal, and of likely alternatives for the tax bill, should be closely examined.

As part of this process, we have the following suggestions:

Information: The facts and figures on revenue losses by industry and size of business, as well as the probable "feed back" from the projected investments, should be fully developed and analyzed before Congress acts.

Size of the cuts: Congress, in our opinion, should seriously consider holding the size of the revenue reductions within limits that will preserve a cushion for a responsible fiscal policy, and hopefully budget balance over the near-term. Such a posture would be more consistent with an anti-inflationary thrust to the tax reduction.

Distribution of benefits between individuals and business: At present, 23 percent of the proposed revenue cuts are allocated to savings and investment. We feel that the percentage should be adjusted closer to the 45-50 percent share approved by the Financed Committee in last year's bill (H.R. 5829). Such a shift would build up the supply-side effect of the bill and reduce the demand side, which we believe is desirable. We hope that experts will assist Congress by exploring the appropriate balance under current and foreseeable economic conditions.

Making the individual tax cuts anti-inflationary: In addition to the relative size of the tax cut, the design of the measure is important. For example, testimony last year estimated that tax cuts equivalent to social security increases would tend to lower inflation.

Recognition of small business: We recommend that the bill target an appropriate proportion of the reductions to new, small, expanding, and independent businesses, which are spread across the entire economy, from capital-intensive to labor-intensive. Nearly everyone now recognizes that small business are the mainspring of economic growth and among the nation's very best weapons against inflation and for improved productivity and efficiency.

SPECIAL SMALL BUSINESS RECOMMENDATIONS

An attachment to this testimony sets forth a series of supplementary proposals which we believe would accomplish these results.

They are diverse because the small business community is diverse. The strength of our private enterprise economy is that dynamic small ventures aggressively seek opportunities wherever they are to be found. As a result, small firms with 20 or fewer employees have been generating over half (52 percent) of net new jobs in America.

We would like to ask that this set of proposals aimed at small business be costed-out by government experts. This committee and the Congress would then be in a position to see which will most benefit the economy within the limits of fiscal prudence and, therefore, which should be enacted now or phased-in over the next several years.

There are two possible points of departure. One is the Administration's bill, the "Economic Recovery Act of 1981" (H.R. 2400 and S. 683) and the other is the "Capital Formation and Productivity" portion of H.R. 5829, the bill which received overwhelming bi-partisan approval by the Senate Finance Committee in August 1980 by a vote of 19-1. Both President Reagan and the 1980 Congressional bill put depreciation reform at the top of their list of priorities. We heartily endorse that cause, for which small business organizations have been fighting for many years. Now that these measures appear close to enactment, we suggest the following modifications so that small business firms are not left out or left behind.

As to depreciation of structures, we could envision a 25-15-10 formula along the following lines: A 25 percent rehabilitation credit for 20-year old buildings, a 15-year

write-off period for real estate generally, a 10-year period for owner-operated business structures, and an allowance for utilities that is equal in years to a 40 percent ADR variance.

Such a formulation should produce very sizable revenue savings compared to the Administration bill. Contained in this formula is a possibility which we wish to see discussed, namely a 5-year spread between structures owned by true small enterprises and real estate structures generally.

Our definition of "owner operated" would be that the owner of a sufficiently large interest in the business (say, somewhere between 20 and 50 percent) be actively engaged in the day to day operation of the firm. Stock owned by family members could be attributed to the active participant.

As to depreciation of equipment, there are two modifications of the proposed formulas we believe to make good sense:

(1) Adoption of a $25,000 of expensing provision, as contained in H.R. 5829, but with the addition of a one percent investment credit. This would be designed to bring the lowest bracket business out even with the capital recovery they would receive under other provisions of H.R. 2400/S. 683. We have heard from one association after another that, on depreciation, we should "make it simple." The suggested change would bring massive simplification to 80 percent of all businesses which reportedly purchase less than $25,000 of equipment each year. It would compensate small firms for the termination of "bonus depreciation" (of 20 percent of the first $10,000 of equipment) which has been in Section 179 of the Code for more than 20 years, but which H.R. 5829 and the Administration proposal would both eliminate.

In terms of a formula, this would set up either a 10-5-3-1 or a 10-7-4-2-1, depending on which framework Congress favors. The 1980 Congressional bill (H.R. 5829); the 1981 proposals by Senator Long (S. 394), Senator Bentsen (S. 317) and Representatives Marriott and McDade (H.R. 3202) are helpful references.

(2) Increasing the amount of used property eligible for the investment credit. SBLC member associations voted in favor of eliminating the ceiling because used machinery is "a way of life" for small and particularly new businesses. We feel it is reasonable to ask, at this point, for an increase from the present $100,000 to $250,000, rather than the $150,000, in H.R. 5829. We would also like to explore the possibility of a "carryover" of the property above the ceiling, so that it would remain eligible to earn the credit in subsequent years. Another suggestion is to raise the ceiling progressively to $500,000.

Corporate rates, we would advocate supplementing the bill by at least the rate reductions as approved in Committee last year. The majority of the 2 million corporations in the country are not capital-intensive. Little more than 20 percent of the nation's jobs are in manufacturing. If companies in light industry, construction, trade, service and other major segments of the economy are to receive capital formation benefits from this bill, so they may also contribute to a stronger economy, this must be done through reducing corporate tax rates.

A key point in structuring any tax bill is the acknowledged fact that most of the 2 million U.S. corporations and 13 million unincorporated firms are simply too small to attract public investors. Only about 11,000 firms are listed on stock exchanges and the NASDAQ over-the-counter market, and therefore have access to national money markets. The rest must rely primarily on retained earnings for their growth. Senator Long's bill (S. 394) restates the finance Committee rate schedule, and Rep. Heftel's bill (H.R. 2949) carries the progression an additional step, to $250,000. This suggests that an inflation adjustment of the ceiling in future years (perhaps $50,000 per year up to $500,000) should also be studied at this time.

Capital Gains Reductions: We have urged the further reduction of these rates to at least the 20 percent as seemingly favored by the Administration and the Finance Committee. The 1978 reductions were notably successful in spurring interest in the stocks of lesser-known corporations and in mobilizing nearly $1/2 billion in fresh capital for new and small ventures. A further reduction would attract additional investment in the most promising start-up and expanding companies.

These enterprises are the ones breaking new ground in technology and new products, but are not often yet profitable enough to pay compensatory dividends. This provision is needed to once again bring reward back in line with risk in this inflationary era. This year, S. 75, proposed by Senator Wallop, has proposed to carry this reduction further, and it should also be examined on its merits.

Estate tax adjustments: Inflation has overtaken the estate tax limitations set by Congress in 1976. Now, a modest home alone can consume the entire $175,000 allowance provided to the next generation under federal law. To preserve a climate for the continuity of family farms and business enterprises, we need realistic estate tax limitations, along the lines of S. 395, introduced this year by Senators Wallop,

Byrd, Boren and others. This is another area where the increases could be phased-in over several years, as they were in the Tax Reform Act of 1976.

Additional small business capital formation provisions: A number of specialized provisions affecting critical points in the process of small business capital formation were also approved last year in H.R. 5829. These included: increased accumulated earnings (to $250,000), increase in Subchapter S shareholders to 25, incentive stock options, broker-dealer profit reserve, elimination of the mid-year W-2 form, remission of the excise tax on diesel fuel for buses, and relief for small firms with inventory problems. We would accept these provisions (now found in S. 394, S. 360 and Senator Bentsen's bill, S. 1140) nearly unchanged, with the exception of the inventory provision.

In this area, we feel that the major effort of the Subcommittee on Equity Capital and Tax of the House Small Business Committee and its Chairman, Rep. Nowak, have paved the way for consideration of a major simplification of this area of tax law. This might be accomplished by including a 10-year stretch-out of LIFO penalty taxes, and the pooling and indexing provisions introduced this year in the Nowak and Moynihan bills (H.R. 2319 and S. 578).

This package of particularized provisions appears to be widely acceptable. We also urge serious study of three companion proposals that emerged from the White House Conference and Small Business Committee hearings of last year: the new issues credit, the capital gains rollover, and the Small Business Participating Debenture. These are found this year in S. 360, introduced by Senators Weicker, Nunn, Durenberger, Baucus and others.

Research and development: For the enterprise that is intensive in research rather than capital equipment, and which may be on the leading edge of the nation's technology, we advocate inclusion of either the 25 percent credit for incremental R&D expenditures (as approved in H.R. 5829, and embodied this year in S. 98, introduced by Senators Danforth, Bradley, Bentsen, Chafee, Heinz and Cranston) or a similar credit for the first $50,000 or $100,000 of R&D expenditures each year. Such a provision might turn out to be the most important initiative in the entire bill for innovation, and thus for America's competitive posture. It would help new and small business most if it covers salary and overhead devoted to R&D, as well as equipment.

ENLARGING THE POOL OF SAVINGS

Encouragement of savings: To increase the overall pool of savings and investment, we are suggesting the enactment of the provision approved in H.R. 5829 on Independent Retirement Accounts and Limited IRAs. However, we would also like to endorse a permanent interest credit equal to the dividend credit, with the total of the two credits rising from the present $400 to higher figures in 1983 and subsequent years. We would investigate conditioning the interest credit on deposits with institutions that have a substantial part of their funds in mortgage loans. Construction is one of the largest single industries in the country and has been a traditional citadel of small and independent business. Allowing this industry to compete for capital would provide a broader base to economic revitalization.

Employment taxes: We believe that advocates of gearing a portion of the individual tax reductions to off-set social security tax increases have made persuasive arguments (see Representative Gephardt and Senator Bradley proposals: in H.R. 1809 and S. 44). The contentions are that such a format will combat inflation by easing demands of workers for greater wage increases to compensate for social security tax increases, and will reduce costs of production for business. One estimate last year, was that such a provision could accordingly reduce the inflation rate by 3/10 of one percent.

We also advocate serious reconsideration of widening the targeted jobs credit, so that it will once again become a more general credit available to small firms. Most of the witnesses in the April 3 hearing conducted by Senator Heinz took a similar position.

Small businesses are the great hope of the economy for taking up the slack left by recessions, population movements and technological change, whether or not caused by greater capital investment. If there is a massive stimulation of capital investment which is neutral or negative for short-term job creation, and little or no encouragement for job-creating small businesses, there is a real question of whether this noble effort will be crash-landed under the weight of additional unemployment and welfare payments. Last year's estimate by the Congressional Budget Office, as you know, was that a one percent increase in the unemployment rate (approximately one million workers) would cause the following budget consequences:

IMPACT OF 1-PERCENT INCREASE IN UNEMPLOYMENT

Increase in spending for fiscal year 1981—$5 to $7 billion; increase in revenues for fiscal year 1981—$20 to $22 billion. Total change in budget position—$25 to $29 billion. Source: Five-Year Budget Projections, Fiscal Years 1981-85, Congressional Budget Office, February 7, 1981.

The argument for general jobs credit is that small business must hire the best available personnel to remain viable. We feel that a bonus could be given for certain more difficult to employ groups. We have always been emphatic that appropriate safeguards should certainly be drafted into the legislation. The statistics thus far show that the general credit produced evidence that it increased employment and held down prices in several important industries such as trade and construction.

We believe that such provisions should greatly assist in improving the personnel side of U.S. productivity efforts, and might turn out to be the "safety net" that counts most in the long run.

Clarifying the status of independent contractors: We hope the long-standing difference in this area can be resolved, so that millions of the smallest businesses can leave behind the uncertainty created by IRS in the past, and can have a "safe harbor" test to guide their future business relationships.

In addition, the Committee should review regulatory and statutory provisions which discourage re-investment by intrepreneurs in their own businesses, such as section 163(d) which restricts the deduction of interest on borrowed investment funds to $10,000.

If the investment is in a large corporation, the dividends paid increase this limit. But, small firms rarely pay dividends, creating a tilt against small firms in the present law. Moreover, high interest rates have reduced the effective value of the fixed $10,000 limitation.

The further application of the new "debt-equity" regulations, under section 385 of the Code, may complicate this area even further for owners of small firms and those who might be willing to add to their capital.

FURTHER EFFORTS TO DEVELOP THE LEGISLATION

We believe we have raised some valid questions about the size and shape of the 1981 tax legislation. After revenue estimates are obtained on the various proposals, Congress will then be in a position to lay out all of the options and to assess the costs of each and the benefits that would be gained by these costs. It can then choose the measure or combination of measures which will best reduce inflation and interest rates, and strengthen productivity, efficiency and economic growth, and will be consistent with the budget posture Congress wishes to achieve.

We would be pleased to try to assist in refining these measures, and fitting as many of them as practicable into an overall bill which accords fair treatment to small busines and thus promotes dynamic economic progress. We believe this approach is in accord with the spirit of the President's proposals. Congressional initiatives and responsibilities, and the national interest.

SHORTENING OF DEPRECIATION LIVES UNDER ADMINISTRATION BILL (H.R. 2400)

(from existing lower ADR limit [or average life actually claimed] to period when bill is fully in effect.)

Asset	Shortening	Investment Credit Increase
Hydro-Elec. Generating Equip.	75.0%	
Factories *	73.0%	
Retail Stores *	72.2%	
Steam Gen. & Distrib. Systems & Oil Pipelines	71.7%	
Telephone Central Office Equip.	68.8%	
Barges, Tugs etc. for Water Transport	65.5%	
Bank Buildings *	65.1%	
Office Buildings *	63.4%	
Oil Refining & Distribution	61.5%	
Warehouses *	59.5%	
RR Cars & Locomotives & Shopping Centers	58.3%	
Primary Metals Manufacturing	55.1%	
Stone, Clay & Glass Mfg.	53.9%	
Apartment Buildings *	43.8%	
Rubber Mfg. Industry	42.0%	
Paper Manufacturing	40.2%	
Office Furniture & Fixtures	37.5%	
Non-Electric Machinery	36.9%	
Chemical Mfg. Industry	36.7%	
Buses	28.6%	
Electric Machinery Mfg	27.5%	
Land Improvements	25.0%	
Motor Transport Freight & Passengers	23.1%	
Electronic Products	23.1%	
Motor Vehicle Mfg. Equipment *	20.0%	3.3%
Airlines Industry	5.0%	
Light Trucks & Truck Tractors	0%	2.67%
Heavy Trucks, Trailors & Containers	0%	3.67%
Information & Data Systems	0%	3.67%
Autos * & Taxis	0%	2.67%
Special Tools Electric Mfg *	0%	2.67%
Special Tools-Metal Working	-67.0%	6.67%

* Based on actual average lives claimed which generally are shorter [illegible]

SOURCES
[illegible]
Actual lives claimed from [illegible] Joint Tax [illegible] 1981 Table [illegible]
Proposed lives from H.R. 2400
Industry composites from testimony of Data Resources, Inc. [illegible] House Small Business Subcommittee on Tax, Access to Equity Capital and Business Opportunities on March 25, 1981 Table 17 page 24

COMPILED BY THE NATIONAL SMALL BUSINESS ASSOCIATION -- April 1981

Prepared Statement of Allen W. Neece, Counsel for Small Business United

SUMMARY

Small Business United (SBU) maintains that the declining economic role of small business is due largely to an inequitable tax system, whose inequities are magnified in times of inflation and high interest rates.

The table below illustrates the problem:

THE RELATIVE TAX DISADVANTAGE OF SMALL CORPORATIONS [1]

	Percentage of total taxes to net worth	
	1969	1974
Size of business receipts:		
$50,000 to $100,000	18.3	30.1
$100,000 to $500,000	14.8	23.5
$500,000 to $1,000,000	15.4	21.3
$1,000,000 to $5,000,000	16.6	19.9
$10,000,000 to $50,000,000	14.7	16.9
$50,000,000 to $100,000,000	13.7	13.6
Over $1,000,000,000	11.8	11.5

[1] These figures were compiled by the Senior Advocate for Tax Policy, Office of Advocacy, U.S. Small Business Administration, May 1980

SBU believes that the tax bias in favor of large concerns will be exacerbated unless those provisions contained in the Bentsen-Danforth bill, S. 1140, the "Small Business Tax Reduction Act of 1981", are included in a Finance Committee reported bill.

We believe the proposals listed below accurately represent the concensus thinking of the vast majority of American small business concerns as reflected by the top delegate recommendations of the White House Conference on Small Business. The projected static revenue loss in the first year would be $4.244 billion. Given that the small business sector is the principal job generator in our economy, we believe targeting less than 10 percent of the tax bill to independent concerns is a modest and reasonable request.

Individual tax custs and depreciation reform are laudible goals but a tax bill containing only these two provisions is deficient in that the capital needs of small business are not adequately addressed.

Specifically, we urge the Committee to include the following:

(1) Depreciation reform: (a) Permit an immediate write-off of the first $25,000 of depreciable property; (b) increase the limit of used equipment eligible for the full investment tax credit to a $250,000 level.

(2) Capital retention: (a) Graduate corporate tax rates on a steeper basis, with the maximum rate taking effect at a $200,000 threshold; (b) Reform estate and gift tax provisions; and (c) Increase the accumulated earnings credit to $250,000.

(3) Capital formation: (a) Reduce capital gains tax rates to 17.5 percent and permit deferred payment (rollover) if the proceeds are reinvested in a small business within 18 months; (b) Authorize granting of employee incentive stock options; (c) increase the permissible number of Subchapter S shareholders from 15 to 25; and (d) authorize a statutory loss reserve of up to $1 million for broker-dealers.

(4) Research and development: (a) Establish a 25 percent credit on incremental expenditures for research and devlopment.

STATEMENT

Mr. Chairman and members of the committee, my name is Allen Neece and I want to thank you for the opportunity to appear before you today. I am Counsel for Small Business United (SBU), a recently organized consortium of nine regional small business organizations that encompasses 25 States.

Many members of those associations composing SBU were also delegates to the White House Conference on Small Business which was held early last year. Many of the Conference recommendations were enacted into law by the 97th Congress. I wish to take this opportunity to thank many of the members of this Committee for their active support in helping to enact those watershed non-tax related measures.

1980 represents what I shall call "Phase One" of the Conference agenda. Enacted were items without revenue consequence—all important to small enterprise—but none which addressed the storied inequities of the Federal tax code.

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Remedying the inequities of that tax system is your challenge under what I call "Phase Two." The SBU Executive Committee, in their montly deliberations, distilled from the lengthy list of proposed tax reforms for small business items that stimulate small business—and the economy in general. Those provisions are reflected in S. 1140 which I will review in a moment.

NEUTRALITY IN THE TAX CODE

First, I would like to talk about a conceptual problem, one so engrained that its ill effects are only now starting to be fully realized.

Like the President, we are anxious to restore neutrality and equity to the tax code. By neutrality I mean that investment decisions should be guided as much as possible by the natural forces of the marketplace.

The tax code should not discriminate against any one sector of the economy. Yet I am afraid that small business has been unintentionally and grievously injured by the code. For example, I see three very serious biases in running a small business and in advising my small business clients.

(1) Economic concentration is increased through the dual tax treatments governing the sale of a small business. Small businessmen are induced to merge their companies by means of a tax free exchange of securities with large businesses rather than enter into taxable transactions with new entrepreneurs who wish to keep a company small, independent, and a vital contributor to the community.

(2) Due to the complexity in the tax code, small business often does not take advantage of tax incentives available to it. The most striking example of tax intricacy is the current depreciation regulations and various tax credits that are available.

(3) Small business has a more difficult time than large business attracting quality senior management. Employees of large corporations are paid very high, competitive salaries; high growth oriented, cash starved small concerns cannot afford to pay high wages. The only alternative form of compensation is stock options, but unfortunately the granting of non-qualified options is not attractive under the code. A tax liability should not be triggered at the time stock options are exercised. Instead, tax liability should occur only at the time those shares are actually sold.

SMALL BUSINESS POTENTIAL

The Administration seeks to reduce inflation, spur capital investment, enhance productivity, and revitalize the American economy. We strongly concur with these laudable goals, but we also believe that the small business sector has not been made a full partner to this endeavor. Without the complete involvement of independent businesses, the economy is unlikely to respond as the Administration and American public desire.

Numerous government, academic and private sector studies have shown that the most prolific producer in the American economy is small business. For instance, 86.7 percent of all new jobs have been created by small companies in recent years. Further, roughly 50 percent of all innovative breakthroughs have been developed by small, independent firms.

The shape of this tax cut—which I view as much reform as reduction—should have three characteristics. First, it should focus squarely on the supply side. Second, a large percentage of the cut should be aimed at small business, simply because only small business can quickly parlay tax savings into the goals the Administration and the Congress seek. And third, within the small business sector, the reduction should accure heaviest to the product-oriented segment, which does the most to radiate its vigor into other components of small business and the economy at large. Even more specific, the cut should have immediately consequences by enabling small business to both retain and attract capital.

Mr. Chairman, we believe that all three of these concerns are addressed by S. 1140, the "Small Business Tax Reduction Act of 1981", which was recently introduced by Senators Bentsen, Danforth, Chafee, Baucus, Boren, and Mitchell. We enthusiastically endorse this measure and urge this Committee to include its various provisions in the tax bill to be marked up next month.

The balance of my remarks speak to the provisions of that bill as well as other small business related features included in the Finance Committee bill reported last fall, H.R. 5829.

ACCELERATED, SIMPLIFIED DEPRECIATION

Depreciation reform is a small business initiative. Long before the advent of the "10-5-3" and the determination by the Business Roundtable that the depreciation regulations deter capital investment, small business was pushing for radical changes

in the system. As early as 1969, SBU member associations proposed depreciation revision to Congress in its annual Small Business Washington Presentation. ADR has simply been too complex to be of meaningful benefit to smaller firms.

A recent survey taken by the Smaller Business Association of New England (SBANE), a member of SBU, substantiates this contention. Asked to rank 14 tax issues in order of priority, SBANE members chose accelerated, simplified depreciation first (Appendix A).

The question is whether the "10-5-3" proposal as drafted is the only answer. We question whether it is and we will leave to other small business witnesses who have or will be appearing before your Committee to explain why. Having said this, I want to emphasize that we are fully supportive of simplified, easily understandable depreciable asset categories and tax credits, particularly as they apply to class lives for light vehicles and capital equipment. Further, to the extent that relief from the expanded investment tax credit and depreciation changes will flow mostly to manufacturers, users of computers, and other high-technology products—great. This segment of small business is desperate in its need to retain more after-tax capital, and to use it for internal growth.

I should add that whatever cost recovery structure is reported, it should include the immediate phase-in feature for the first $100,000 of annual purchases. This feature of H.R. 2400 should be retained as it firmly recognizes the need for small business growth by internal capital generation.

The committee should also support as it did in H.R. 5829, the expensing—or immediate write-off—of the first $25,000 of annual capital expenditures. This provision is particularly important during a period of high interest and tight credit which discriminates against capital-starved small business. Again, the link must be made between this tax cut and provisions to enchance internal growth by small business.

Also under the heading of reform, we stongly urge an increase in the amount of used equipment eligible for the full investment tax credit. The current ceiling is $100,000, sadly inadequate in light of inflation. The limit should be raised to at least $150,000 and preferably $250,000.

CAPITAL RETENTION

Again, we harken to reform in the tax code. Why should a company having sales of $100,000 have an effective tax rate two and one-half times that of a corporation with sales of $50 million? (See table on summary page.)

A smaller company is now almost totally dependent upon leveraging after-tax earnings to meet its capital requirements, compared to a larger company's access to money at below prime rates as demonstrated in recent Congressional hearings.

A modest graduation in the tax scale—which is all small business has ever sought—is hardly asking for a "break" as some opponents contend.

We repeat: the more after-tax earnings are retained by product-oriented small business, the more the economy prospers. When these types of companies are making products which create jobs, their employees are the ones who become the customer base for the retail and service concerns. To that end, the surtax exemption should be immediately raised to at least a $200,000 level.

Before leaving the subject of capital retention, I want to point out that estate and gift tax reform is long overdue and we applaud the President's statement of last October that these taxes should be abolished. Scarce cash is being used by family-oriented small concerns to pay for an insurance policy that will assure business continuity upon the principal's death. Estate taxes are punitive—they work to discourage innovation and industry by an enterpreneur, particularly as he grows older, especially if his or her company is entering a high growth mode. In short, the more a company grows and prospers, the more expensive it becomes to keep the Federal government at bay in the future.

IN STILL ANOTHER AREA, SBU WANTS TO BE FIRMLY ON RECORD IN SUPPORT OF INCREASING THE ACCUMULATED EARNINGS CEILING TO AT LEAST $250.000. THE PRESENT CEILING IS UNREALISTICALLY LOW. IT PRECLUDES A FIRM FROM SAVING SUFFICIENT CASH FOR GROWTH AND EXPANSION PURPOSES, THEREBY FORCING IT TO BORROW DURING A PERIOD OF RECORD HIGH INTEREST RATES.

CAPITAL FORMATION

We urge the Committee to consider seriously a rollover provision that would allow for deferred payment of capital gains taxes if the capital proceeds are reinvested in a smaller company within 18 months.

In addition, a provision should be included to promote and stimulate capital formation by increasing the exclusion to 75 percent and thereby reducing the maximum rate to 17.5 percent. Again, other organizations will speak more fully to this issue, but we want to underscore the importance of this proposal to the small business community.

SBU would like to focus on one other provision that may not draw the attention of other small business interest groups, and that is the need for authorizing the issuance of small business participating debentures (SBPDs). To illustrate this point, I would like to use as an example the founding of an actual small business.

This business started with $75,000 in borrowed capital from six relatives of the enterpreneur. His experience is not unique. Many enterpreneurs find their friends, relatives, suppliers, and customers to be ready sources of capital. However, they are not usually equity participants who might dilute management independence. But a new financial instrument—equally attractive to investor and borrower—would greatly ease the task of raising money to start or expand a small company. An SBPD is precisely the type of creative and doable solution we need for the unique capital formation problems of small business.

This instrument is unique in that it has both debt and equity features. The company can deduct both the interest and the participating earnings portion of the fixed term debenture while the holder can treat his share of the profits as capital gains. We believe that this type of incentive could work wonders for a smaller concern that does not intend to go public, but nevertheless has the potential for substantial growth.

RESEARCH AND DEVELOPMENT TAX CREDITS

Small businesses produce about one-half of all new inventions in our country today, and do so on a much more cost-effective basis than large corporations. Therefore, SBU endorses a 25 percent tax credit for any incremental expenditures for research and development as proposed by Senator Danforth. Such a proposal has considerable support in Congress and we think it represents a partial solution to the problems in industrial innovation particularly as it applies to small high technology companies that are in their formative growth stages.

Small R&D firms are particularly strapped for cash. The tax credit initiative not only affords them a smoother cash flow, but it also acts as an inducement to innovative thinkers in large corporations who are contemplating entering business for themselves.

Thank you for inviting SBU to express its views on tax policy and small business' role in the economic recovery of the nation.

APPENDIX A

SBANE BAROMETER SURVEY, FEBRUARY 1981 "WHERE SHOULD YOUR TAXES BE CUT?"

SBANE members were asked to rank several tax cutting measures. Below are the top 10 vote-getters in order of finish:

(1) Simplify and accelerate the depreciation system, (2) raise the surtax exemption—the point at which the maximum corporate tax rate takes effect, (3) lower the capital gains tax rates, (4) reduce individual tax rates, (5) allow a "roll-over" on capital gains taxes from one small business to another (6) steepen the graduation on corporate taxes, (7) abolish estate and gift taxes, (8) expand the exclusion from accumulated earnings tax, (9) increase the investment tax credit applied to used equipment, and (10) establish a first-year write-off on the inital $25,000 of annual purchases.

Senator DURENBERGER. The last witness is Mr. John J. Sweeney, president, Service Employees International Union.

[Pause.]

Senator ARMSTRONG [acting chairman presiding]. The committee is now pleased to welcome Mr. John J. Sweeney, president of the Service Employees International Union.

Mr. Sweeney.

STATEMENT OF JOHN J. SWEENEY, PRESIDENT, SERVICE EMPLOYEES INTERNATIONAL UNION

Mr. SWEENEY. Senator, I am happy to have the opportunity to testify here today, on behalf of the 650,000 members of the Service

Employees International Union, on the President's proposed tax program.

With me is our legislative representative, Dick Murphy, and our consultant on tax legislation, Bob McIntyre.

The Service Employees represents workers in the service industries which include health, buildings, offices, Government employees.

We are terribly concerned about the the effects of the President's tax program on both the tax burdens of our members and on the growth of our economy.

The President's program will not provide real tax relief for the overwhelming majority of service workers.

In fact, most of our members will be paying a larger share of their income in taxes under the plan, because of inflation and increased payroll taxes.

The average worker in the services' sector make only about $10,000 a year. Many are paid at only the minimum wage.

For taxpayers earning $10,000 or less, the Reagan tax cut turns out to be a 28-percent tax increase, after bracket creep and higher social security taxes are taken into account.

The highest income tax payers, on the other hand, would receive real tax cuts, after inflation, of almost $22,000 a year.

The plan also reduces the top rate on capital gains from 28 percent, to 20 percent. When it is fully in effect, the tax rate on the gains of the wealthiest speculator in gold, silver, or real estate will be lower than the tax rate paid by a worker with just $15,000 in taxable income.

When we add this all up, we see little by the way of incentive for our members, under the President's plan.

We endorse and encourage your consideration instead of the AFL-CIO proposal for a 20-percent payroll tax credit against income taxes.

This plan just about offsets the impact of bracket creep and the new payroll tax rates for the 80 percent of all taxpayers earning under $30,000 a year.

The 20-percent credit would in effect cut marginal tax rates for workers by about 3 percentage points, a larger decrease for most taxpayers than they would get from the first year of Kemp-Roth.

Now let's turn to the business side of the President's plan. 10-5-3 is bad economics as well as bad tax policy. It creates negative tax rates averaging 16 percent, converting the corporate income tax into a corporate income subsidy.

It provides wildly different subsidy levels for different kinds of investments.

Both the average effective tax rate and the range of tax rates on different investments will fluctuate dramatically with the rate of inflation.

The inevitable result can only be gross distortions in investment, more tax shelter activity diverting capital from productive uses, and reduced productivity and growth in our economy.

Instead of removing the basic defects of current depreciation law, 10-5-3 only compounds them. It invites investors to make their decisions not on the basis of the economic merits of an investment but, instead, according to its tax advantages.

I cannot help but wonder how an administration which portrays itself as the champion of a free market economy can justify its espousal of such a proposal.

Of course, much of the rhetoric surrounding 10-5-3 cites the competitive problems of particular American industries such as autos, steel, and electronics.

But it is hardly rational to point to problems in particular industries and then try to use these problems as justification for huge tax subsidies targeted largely to industries which have no need of Government assistance.

Where Government help is appropriate, it should be provided. But only on a carefully targeted basis and only with assurances that the aid will be put to good use.

In other words, instead of the economy-distorting subsidies provided by 10-5-3, Congress should adopt the plan put forward by the AFL-CIO.

In contrast to the one-half of a trillion dollars "gold bandaid" called 10-5-3, the AFL-CIO plan moves us into the direction of our international competitors by joining labor, Government, and business to develop a national industrial policy to improve our competitive position in the world economy.

Tax, credit, and other policies would be coordinated to assist companies with a demonstrated need and a cogent plan for revitalization or expansion.

The AFL-CIO plan also provides tax relief to business through a 5 percent payroll tax credit. We believe this would be a special help to small businesses and to the labor intensive service industry.

At the current high level of unemployment, we need proposals such as this which will encourage hiring new workers.

We do not dismiss the need for depreciation reform to bring the current system into conformity with economic realities.

We believe the committee should adopt an approach which equalizes effective tax rates for all investments, which is no longer sensitive to inflation, and which preserves the integrity of the corporate income tax.

To employ depreciation rules as a tax subsidy device as 10-5-3 proposes is simply a costly and counterproductive confusion of two different policy objectives; the need for depreciation reform and the need for targeted aid to particular industries.

Finally, we urge the committee to eliminate some of the wasteful and counterproductive tax subsidies in current law which undermine both productivity and tax fairness.

We have attached to our testimony a list of tax subsidies we think should receive priority attention.

The economic forecasts contained in the President's program have been called "the rosy scenario." But it is a lot rosier for some than others.

For the period from 1980 to 1986, it calls for wages to go up 80 percent while payroll taxes go up 104 percent.

It says personal income will rise 81 percent while personal income taxes will increase 80 percent, leaving real tax cuts only for those in the highest brackets.

It says corporate profits will go up 87 percent while taxes on corporate profits will increase less than 13 percent.

What this adds up to is a massive tax shift which rewards the wealthy, large corporations, and the speculators, the tax shelter industry and fast-buck artists, while leaving the vast majority of Americans whose income comes from their wages, to pay an even larger share of the cost of Government. It's an approach we reject and we hope you will too.

Thank you.

Senator ARMSTRONG. Mr. Sweeney, we are grateful for your testimony. I couldn't help thinking, as I listened to your testimony, and also reviewed the material attached, that you are staking out a position which is substantially at variance from that which is taken by at least some of the other witnesses before this committee, and what I would judge to be quite an unpopular position in the country, although I can't prove that.

You are against the President's tax program. You are against the 10-5-3 depreciation.

So, I must compliment you for your willingness to stake out a position, particularly on depreciation, which I think you will find is quite unpopular.

I want to be sure I understand. It is not just 10-5-3 you are against. It is the idea of faster writeoff for depreciable assets. Have I understood you correctly?

Mr. SWEENEY. Well, our basic position is that we do not think that Government assistance for business should use depreciation as a criteria for handing out subsidies.

Senator ARMSTRONG. The notion of depreciation—I don't mean tax treatment depreciation, I mean the notion of depreciation of accounting matters, is that assets have a certain limited life.

Therefore, depreciation seeks to assign to the limited life the amount of charge which should be borne by current production, for the month, for the year, whatever it is.

In other words, how much of the assets have been used in the course of producing whatever it is that the company is producing.

So, the idea is assigning or allocating properly, expenses for what is produced.

The way the Government gets into this is that the Government has artificially decided that it will regulate the amount of depreciation which a firm may allocate to a particular unit of production; that is, it sets the guidelines.

I fail to see, and maybe there is something I missed, but I fail to see how you can say that this has something to do with business subsidizing.

It appears to me that whatever the rate of depreciation is, any asset may only be depreciated up to cost, whatever that turns out to be.

Thereafter, further depreciation deductions can't be taken. So, isn't it really a question of when the deduction is taken, rather than how much?

Mr. SWEENEY. Well, if I may, I would like to ask Mr. McIntyre to further clarify our position on that.

Senator ARMSTRONG. Good.

Mr. MCINTYRE. Senator, the tax depreciation rules, even under current law are faster than most businesses use on their books, as you know.

What we are talking about in a corporate profit tax is trying to take a measure of corporate income and then apply whatever Congress thinks the appropriate tax rate is to it.

Now, if by——

Senator ARMSTRONG. Depreciation is a factor in determining what——

Mr. MCINTYRE. In determining what their income is; that is right. If, by fast depreciation a company is able to show very little or in many cases no income, then the Government would never collect any taxes from that company, you won't have a corporate income tax.

Mr. Sweeney is suggesting that we ought to maintain the integrity of the corporate income tax by having depreciation rules that make economic sense.

Then, if we need to give assistance to companies in particular industries, we ought to target it in ways that make rational sense, rather than just trying to have a system that arbitrarily increases depreciation deductions and takes most corporations off the tax rolls.

Senator ARMSTRONG. My purpose, by the way, is not to argue the issue. I will have a chance to argue it at some time. I just want to be sure we understand each other.

My understanding is the President's proposal for 10-5-3 is not to put everybody on 10-5-3, but to simply say that as a matter of law, corporations may not depreciate their assets faster than 10-5-3; that is, 10 years for some assets, 5 years for others, and 3 years for others.

It would not force anybody to go to that. It would only say that the guideline of 10-5-3.

Mr. MCINTYRE. Pardon me, Senator. Actually, the 10-5-3 plan would be mandatory for tax purposes.

Senator ARMSTRONG. No, I think not. Let me get the staff to advise me.

I beg your pardon. I am getting advice from this side of the table that is correct.

Let me ask counsel: Are you saying if companies have an asset that falls into the 10-year classification, it may not depreciate it in 12 years or 15 years, rather than 10?

Mr. LEDUC. Yes.

Senator ARMSTRONG. Is that what you are advising me?

Mr. LEDUC. Yes, sir.

Senator ARMSTRONG. You are telling me that if a company owns an asset which is eligible for 10-year depreciation, under the President's proposal, that it must depreciate it in 10 years and may not elect to take a longer period to depreciate it?

Mr. LEDUC. Yes, sir.

Senator ARMSTRONG. I am advised by counsel that is what the bill says and that is enough.

I predict to you that it will not pass in that form. Counsel is better informed than Senators on such matters, but I can't imagine. It must be a drafting error. That has never been, so far as I am aware of, the principle of the Tax Code, to require people to depreciate their assets more rapidly than they might otherwise choose to do so.

I just can't—I am indebted to you for bringing that to my attention.

Mr. McINTYRE. Senator, that requirement is only for tax purposes, of course. On their books they can use any lives that are appropriate.

Senator ARMSTRONG. I can't believe that we will require a company to depreciate in the Tax Code, require a company to depreciate its assets more rapidly than it wishes to do so.

Congress will not do that, in my opinion. I am amazed the administration would make such a proposal.

Mr. SWEENEY. Senator, the members of the Service Employees International Union would like to take credit for persuading you to change your position. [Laughter.]

Senator ARMSTRONG. Duly noted.

I would say I have just been summoned to the floor, for a vote. I believe we are at the end of the scheduled business of the committee for the afternoon.

I am grateful to you for your testimony.

I would like to ask just one other question, just as a matter of curiosity. It really does not bear on the merits of the legislation.

I believe you testified that you represent 650,000 members.

Mr. SWEENEY. Yes, Senator Armstrong.

Senator ARMSTRONG. Is the testimony that you have submitted to be understood as the testimony of the leadership of the union, your personal testimony or generally that it is the consensus of 650,000 people that you represent?

Mr. SWEENEY. Senator, I——

Senator ARMSTRONG. Sometimes, by the way, people ask me the same question.

Mr. SWEENEY. I would say that more confidently than I would say maybe on some other issues of legislation, but certainly on tax legislation I would say that the position that I have stated is the position of all of our members, because we represent service workers, organized and unorganized, who are at the bottom of the economic level, who are low-paid workers.

By all assessments of the President's proposal, it unfairly rewards corporate interests and it is at the expense of the American worker, especially the low-paid worker.

Senator ARMSTRONG. How did you determine that this was the view of the 650,000 people you represent?

Mr. SWEENEY. Well, we have a union that has had a long history of a very active grassroots political and legislative machinery. I am relying on the information we are getting from our membership, their reaction to our newspaper articles, and meetings with our members—we travel around the country very actively. I say this as forthrightly as I can that I believe that the membership of our union would stand behind the position we have taken on this issue.

Senator ARMSTRONG. Thank you, again. I very much appreciate your testimony and your concern expressed.

Mr. SWEENEY. Thank you for the opportunity.

Senator ARMSTRONG. Thank you.

We will adjourn at this point.

[Whereupon, at 3:23 p.m., the hearing adjourned, subject to the call of the Chair.]

[Statement follows:]

PREPARED STATEMENT OF JOHN SWEENEY, INTERNATIONAL PRESIDENT, SERVICE EMPLOYEES INTERNATIONAL UNION, AFL-CIO, CLC

I am John Sweeney, International President of the Service Employees International Union, and on behalf of the more than 650,000 members of SEIU, I thank you for the opportunity to testify here today on the President's proposed tax program.

SEIU represents workers in the service industries—health, buildings, offices, and government employees. We are terribly concerned about the effects of the President's tax program on both the tax burdens of our members and on the growth of our economy.

The President's program will not provide real tax relief for the overwhelming majority of service workers. In fact, most of our members will be paying a larger share of their income in taxes under the plan because of inflation and increased payroll taxes.

The average worker in the services sector makes only about $10,000 a year. Many are paid at only the minimum wage. For taxpayers earning $10,000 or less, the Reagan tax "cut" turns out to be a 28-percent tax increase, after "bracket creep" and higher social security taxes are taken into account. The highest income taxpayers, on the other hand, would receive real tax cuts—after inflation—of almost $22,000 a year.

The plan also reduces the top rate on capital gains from 28 to 20 percent. When it is fully in effect, the tax rate on the gains of the wealthiest speculator in gold, silver or real estate will be lower than the tax paid by a worker with just $15,000 in taxable income.

When we add this all up we see little by way of "incentive" for our members under the President's plan. We endorse and encourage your consideration instead of the AFL-CIO proposal for a 20-percent payroll tax credit against income taxes. This plan just about offsets the impact of bracket creep and the new payroll tax rates for the 80 percent of all taxpayers earning under $30,000 a year.[1] The 20-percent credit would in effect cut marginal tax rates for workers by about 3 percentage points, a larger decrease for most taxpayers than they would get from the first year of Kemp-Roth.

Now let's turn to the business side of the President's plan. 10-5-3 is bad economics as well as bad tax policy. It creates negative tax rates averaging 16 percent, converting the corporate income tax into a corporate income subsidy. It provides wildly different subsidy levels for different kinds of investment. Both the average effective tax rate and the range of tax rates on different investments will fluctuate dramatically with the rate of inflation.

The inevitable result can only be gross distortions in investment, more tax shelter activity diverting capital from productive uses, and reduced productivity and growth in our economy. Instead of removing the basic defects of current depreciation law, 10-5-3 only compounds them. It invites investors to make their decisions not on the basis of the economic merits of an investment but instead according to its tax advantages. I cannot help but wonder how an Administration which portrays itself as the champion of a free market economy can justify its espousal of such a proposal.

Of course, much of the rhetoric surrounding 10-5-3 cites the competitive problems of particular American industries such as autos, steel and electronics. But it is hardly rational to point to problems in particular industries and then try to use problems as justification for huge tax subsidies targeted largely to industries which have no need of government assistance. Where government help is appropriate, it should be provided. But only on a carefully targeted basis and only with assurances that the aid will be put to good use.

In other words, instead of the economy-distorting subsidies provided by 10-5-3, Congress should adopt the plan put forward by the AFL-CIO. In contrast, to the one-half trillion dollar "gold band-aid" called 10-5-3, the AFL-CIO plan moves us in the direction of our international competitors by joining labor, government and business to develop a national industrial policy to improve our competitive position in the world economy. Tax, credit, and other policies would be coordinated to assist companies with a demonstrated need and a cognent plan for revitalization or expansion.

The AFL-CIO plan also provides tax relief to business through a 5-percent payroll tax credit. We believe this would be of special help to smaller businesses and to the

[1] On the average, for individuals earning under $30,000 a year, a 20-percent payroll tax credit would offset all but $9 per taxpayer of the tax increases from inflation and higher social security taxes.

labor-intensive service industry. At the current high level of unemployment, we need proposals such as this which will encourage hiring new workers.

We do not dismiss the need for depreciation reform to bring the current system into conformity with economic realities. We believe the Committee should adopt an approach which equalizes effective tax rates for all investments, which is no longer sensitive to inflation, and which preserves the integrity of the corporate income tax. To employ depreciation rules as a tax subsidy device as 10-5-3 proposes is simply a costly and counterproductive confusion of two different policy objectives: the need for depreciation reform and the need for targeted aid to particular industries.

Finally, we urge the Committee to eliminate some of the wasteful and counterproductive tax subsidies in current law which undermine both productivity and tax fairness. We have attached to our testimony a list of tax subsidies we think should receive priority attention.

The economic forecasts contained in the President's program have been called the rosy scenario. But it is a lot rosier for some than others. For the period from 1980 to 1986, it calls for wages to go up 80 percent while payroll taxes go up 104 percent. It says personal income will rise 81 percent while personal income taxes will increase 80 percent, leaving real tax cuts only for those in the highest brackets. And it says corporate profits will go up 87 percent while taxes on corporate profits will increase less than 13 percent.

What this adds up to is a massive tax shift which rewards the wealthy, large corporations, and the speculators, the tax shelter industry and fast-buck artists, while leaving the vast majority of Americans whose income comes from their wages to pay an even larger share of the cost of government. It's an approach we reject and we hope you will too.

1984 IMPACTS PER TAXPAYER[1] 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 (dollars in thousands)	Average tax cut under Reagan plan	Average tax increase due to "bracket creep" and payroll tax hikes[2]	Average net change in tax liability	Percent change in tax liability[3]	Percent of all taxpayers[4]
Under $10	$81	$204	+$123	+27.8	34.2
$10 to $15	367	487	+120	+7.1	14.7
$15 to $20	616	656	+40	+1.4	12.1
$20 to $30	978	967	−10	−0.2	18.9
$30 to $50	1,742	1,655	−86	−1.1	15.2
$50 to $100	3,930	3,298	−632	−4.1	4.0
$100 to $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 (total)	883	838	−45	−1.1	100.0

[1] Averages for all individuals subject to income and/or social security payroll taxes.

[2] "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 percent 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 percent. 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.

[3] Total income and payroll tax liability.

[4] Individuals subject to income and/or payroll taxes.

Source: Based on data from the Joint Committee on Taxation, April 13 and 27, 1981.

SEIU PROPOSAL TO ELIMINATE WASTEFUL AND COUNTERPRODUCTIVE TAX SUBSIDIES

Tax shelters, speculation, corporate takeovers, runaway plants and the export of American jobs overseas all are encouraged by provisions of our current tax system. Repealing these 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 also will enhance the effectiveness of incentives for productive investment with which they will no longer be compting. Such changes also 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.

The following wasteful and inefficient tax subsidies should be repealed at once:

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. The following steps need to be taken immediately:

The maze of tax treaties and IRS regulations which allow foreign tax havens to flourish must be completely overhauld 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 Domestic International Sales Corporation (DISC) tax shelter for exporters. Repeal of DISC would save taxpayers $1,830 million 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 will save taxpayers $1,095 million in fiscal 1982.

Deferral of taxes on overseas income shelters profits made in foreign tax havens and encourages American multinationals to retain earnings overseas instead of bringing them home to invest in the American economy. Repeal of the deferral will add at least one half billion dollars in otherwise uncollectable revenues in fiscal 1982.

Tax subsidies for the oil and gas industry

As a result of the enormous windfall profits generated by decontrol, the oil industry now controls 40 percent of all manufacturing profits in the U.S. compared to just 18 percent three years ago. Continuation of huge multi-billion dollar tax subsidies to the oil industry clearly can no longer be justified. The industry pleaded the cause of "free enterprise" when it wanted prices decontrolled. Now it should be forced to live with its own "full enterprise" rhetoric when it comes to subsidies. Percentage depletion and the expensing of intangible drilling costs should be repealed and abuses of the foreign tax credit should be ended. These changes will yield more than $5 billion in fiscal 1982.

Capital gains exclusion for unproductive investments

The provision allowing taxpayers to exclude 60 percent of the income they receive as capital gains overwhelmingly benefits the highest income taxpayers. The Reagan tax plan adds insult to injury by reducing the maximum rate on the capital gains of the wealthiest investor to about the same level as the bottom tax rate on the wages of the lowest-paid worker.

In addition, this provision 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 speculation in gold, silver, commodities, stamps, coins, antiques, jewelry and art.

At the very least, preferential treatment of capital gains should not be given to such unproductive investments.

Represtentive James Shannon (D-Mass.) has proposed a bill which denies the capital gains exclusion to non-productive investments. Some estimates indicate that such an approach could cut the capital gains loophole by as much as one-third (or $6 billion). In addition, it would significantly reduce the scope of 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.

Commodity tax straddles

Commodity tax straddles are a perfect example of tax shelter abuses which divert resources away from productive uses. No one has ever attempted to offer an economic justification for these tax avoidance devices which are estimated to cost the government between $1 billion and $3 billion a year. They should be curtailed at once.

Industrial development bonds

The use of tax-exempt bonds to provide interest subsidies to private industry, which frequently has been used to subsidize runaway plants, is a wasteful expenditure of federal funds and a boondoggle for the wealthy. The largest users of these bonds are McDonalds and K-Mart. There is a growing consensus that use of these bonds should be curtailed. Such action could yield as much as $2 billion in new federal revenues.

[From the Washington Post, May 10, 1981]

OVER-GENEROUS "10-5-3" EQUIVALENT TO NEGATIVE TAX RATE FOR COMPANIES

The corporate tax rate has been established by Congress at 46 percent. But because of many different investment tax subsidies introduced over the years, the actual effective tax rate on corporate income is no more than half that, about 25 percent.

Now, suppose someone were to decide to give further benefits to business so that the corporate tax rate would be reduced to zero? In all probability, you would say that wiping out the corporate tax rate would make no sense at all.

But that is precisely the effect of President Reagan's proposal for new and juicy depreciation allowances under the so-called "10-5.-3" plan. The numbers 10, 5, 3 refer to the span of years over which a company can deduct the cost of new investments from its tax payment: 10 years for buildings, 5 years for equipment and machinery, and 3 years for vehicles—which means that a business would get its money back for investment outlays about twice as fast as at the present.

The trouble is that when this generous system is coupled with the large investment tax credits available on the same depreciable assets, it overcompensates. According to a study done by Dale Jorgenson and Martin Sullivan at the Harvard Institute of Economic Research in March 1981, the excessively generous "10-5-3" write-off eventually would result in a 16 percent negative average tax rate for corporations, assuming continuation of present inflation rates. (If inflation rates move down, the negative rate would be even higher.)

Consider what a 16 percent negative tax rate implies. That means that instead of getting a tax return on the income from corporate investments, Uncle Sam would get no tax payment, and would be providing a 16 percent subsidy to boot. To the ordinary citizen who earns a salary and pays a stiff tax with no loopholes or shelters to ease the pain, that is nothing short of mind-boggling.

The deductions and credits available under 10-5-3, says Robert S. McIntyre of the Washington-based public interest lobby, the Citizens for Tax Justice, "would not only shelter the income from depreciable assets, but there would be enough left over to shelter income from other investments, such as land and financial assets."

Surely, the next move will be to make the excess credits refundable, so the Treasury would have to pay the "negative tax" in cash!

This ridiculous situation arises out of America's poor record in achieving productivity gains in the last decade. Almost without exception, poor productivity is attributed to the lack of adequate "incentives" for business and investment. What's an incentive? Why, that's a big tax deduction to induce a business person to modernize or expand.

The buzzwords in Washington these days are "capital formation." Provide the right tax concessions, supply-side economists say, and you automatically will boost the accumulation of capital, which in turn will provide a pool of money for investment. That's the simplistic rationale for inclusion in President Reagan's economic recovery program a variation of the "10-5-3" system, intended to offset the higher replacement costs arising out of inflation.

But even that is not the whole story. Apart from the excesses of "10-5-3," a big push to stimulate capital formation—despite conventional wisdom—may not be the most efficient way to get productivity rising again. It's almost heretical to challenge the establishment on this issue. Almost everybody, from Sen. Edward Kennedy (D-Mass.) to Sen. Jesse Helms (R-N.C.), from labor unions to the moral majority has a good word for the need to stimulate business investment.

The New York Stock Exchange has worked up a complete study, featuring an "economic performance index," which shows that only Britain and Italy had lower EPIs than the United States in the past six years. The Big Board study, replete with charts, got an approving nod from the respected London publication. The Economist which—although it picked a few holes in the NYSE's conclusion—observed that because of what they labeled a sharp decline in new U.S. investment, "it is no wonder that American industry has been in relative decline, and its productivity growth has slumped."

But some respected voices raise doubts. New York financial market analyst Peter L. Bernstein is one. Brookings economist Martin Bailey is another. They say that the historical record doesn't show a close match between greater capital formation and increased productivity.

Bernstein believes that a "shove" from the Reagan proposal actually might lead the nation into an investment boom—and one creating the kinds of expended capacity that we don't need. A less inflationary way to boost capital formation, he suggests, would be to support broader measures to stimulate economic growth.

He cites the record of the years 1965-73, when an investment boom was triggered by tax changes introduced by the late President Kennedy—a period now affectionately cited by supply-side tax-cutters. What actually happened was that inflation rates tripled, and the average productivity growth slumped to an annual rate of 2.1 percent from 2.9 percent during the earlier 1958-64 years when investment was at a low ebb.

I think these arguments are persuasive, and one has to look to the Congress to save the country from the excesses of "10-5-3." There is a Democratic alternative, sponsored by Rep. James Shannon (D-Mass.) and others, which improves current depreciation schedules for specific classes of assets. Its backers say it would cut the current effective corporate tax rate from 25 to 15 percent, which is generous enough.

The link between capital intensity and productivity improvement is, at best, questionable. The nation faces such staggering real bills that it needs to guard against giveaways that would generate sheltered profits and do nothing to boost productivity. Think of the screams you'd be hearing if Reagan were proposing a "negative income tax" of 16 percent for the poor!

INDUSTRIAL COUNTRIES INCREASE THEIR USE OF TAX INCENTIVES TO STIMULATE INVESTMENT

by George F. Kopits

George F. Kopits is senior economist with the European Department of the International Monetary Fund. *This article is reproduced, with permission, from the April 20, 1981, edition of the IMF Survey. A previous article by Mr. Kopits, entitled "Tax Provisions to Boost Capital Formation Vary Widely in Industrial Nations," appeared in Tax Notes for November 17, 1980, starting at page 955.*

In this article, Kopits updates his earlier analysis in light of recent European and U.S. developments. His updated figures indicate that, in general, the United States will provide larger subsidies for capital investment than do other industrial countries, if the Reagan Administration tax proposals are enacted in the form in which they have been proposed by the President.

Confronted with high rates of inflation and a continued slowdown in the growth of labor productivity, and with the attendant erosion in international competitiveness of their products, several industrial nations are stepping up the subsidization of investment activity this year. This policy effort involves mainly the introduction of various forms of accelerated tax depreciation and increases in investment tax credits or cash grants, thus sustaining the trend toward further liberalization of capital cost recovery.

European and U.S. Programs

France has adopted a 10 percent additional first-year tax deduction for investment undertaken since October 1980 in new assets depreciable under the declining balance method. The Netherlands has raised permanently the basic rate of cash grant (refundable investment tax credit) provided for most machinery and equipment purchases from seven percent to 10 percent, following temporary increases to 10 percent in June 1980 and to 12 percent between October 1980 and June 1981. In February, as part of its Social and Economic Recovery Program, Belgium introduced an exemption of up to five percent of taxable corporate income for reinvested earnings. In the United Kingdom, the budget submitted to Parliament in March contains a proposal to raise from 50 percent to 75 percent the initial deduction for industrial buildings purchased since then.

However, the most far-reaching change has been proposed in the United States under the Program for Economic Recovery, unveiled by the new Administration in February. In broad terms, the proposal (a slightly modified version of the earlier Conable-Jones bill) envisages replacing the existing asset lives by the so-called 10-5-3 accelerated cost recovery system and applying a combination of double-declining-balance and sum-of-the-years-digits methods of depreciation over the new lives. These lives are three years for motor vehicles, five years for other machinery and equipment, and ten years for most industrial buildings. The proposal also provides for an extension of the 10 percent investment tax credit to some structures and to all equipment except motor vehicles, which would qualify for a six percent credit.

Tax Subsidy Rates

Tax subsidy rates, inclusive of these measures, have been updated through 1981 for nonresidential fixed investment, expressed as a percentage of the market price of assets, on the basis of the methodology used in a previous article (see *Tax Notes*, November 17, 1980, pp. 955-958), namely, they have been calculated from the difference in the present value of tax depreciation, additional deductions, tax credits and grants, and of economic depreciation under an inflation-neutral tax system. It is assumed that the nominal discount rate is 10 percent, the inflation-adjusted discount rate is five percent, and the corporation income tax rate is 46 percent for all countries.

For nonresidential fixed investment as a whole (see table 1) the relative position of some countries is expected to change significantly during 1981. Notably, the United

Table 1

TAX SUBSIDY RATES ON NONRESIDENTIAL FIXED INVESTMENT[1]

Positive values indicate a subsidy; negative values represent a tax.

Country	1973	1980	1981
Belgium	-2.5	-2.5	-2.5
France	-0.1	-0.1	2.9
Germany, Fed. Rep	-6.1	-4.2	-4.2
Italy	4.6	5.2	5.2
Japan	-4.6	-4.6	-4.6
Netherlands	-5.2	0 2	2.7
United Kingdom	6 5	6.9	7.8[2]
United States	1.1	3.9	11.8[3]

[1]Figures are calculated as a percentage of asset price. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is five percent.

[2]Calculated on the basis of the budget bill

[3]Calculated on the basis of the Reagan Administration proposal.

Several industrial nations are stepping up the subsidization of investment activity this year. . .

States (assuming full implementation of the 10-5-3 system) would move to the top of the list among industrial countries with a 12 percent subsidy, ahead of the United Kingdom and Italy, with eight percent and five percent subsidy rates, respectively. In France and the Netherlands, the subsidy rates increase from zero by about three percentage points. The Federal Republic of Germany and Japan seem to maintain the least generous fiscal treatment of capital cost recovery, with tax rates in excess of four percent.

Table 2 lists the tax subsidy rates on fixed assets used predominantly in manufacturing (industrial buildings, metal-working machinery, other special industry machinery, and general industry machinery), weighted by the share of each asset category within total investment in these assets for each country. As presumably these assets enter more directly in the production of tradable goods, the resulting tax subsidy rates should have a more direct influence on the relative international competitiveness of these countries. The ranking of several countries is affected by the concentration of fiscal incentives in the manufacturing sector. Upon enactment of legislative proposals, in both the United Kingdom and the United States the subsidy rate would climb to 13 percent, while the French, Italian, and Netherlands rates are clustered around five percent. At the other extreme, the German tax rate remains at more than five percent. Interestingly, the tax subsidy rates on manufacturing assets exhibit wider variation across countries and a larger average increase between 1973 and 1981 than the rates on all nonresidential fixed assets. A more detailed measure of tax subsidy rates, by asset groups, is given in table 3 for 1981.

The tax subsidy rates shown here compare the relative quantitative importance of fiscal subsidies provided for new investment in a particular asset aggregate in each country. They do not reflect, however, the actual value of these subsidies to investors, insofar as they exclude intercountry differences in income tax rates and discount rates—given the lack of relevant data for the most recent years.

Table 2

TAX SUBSIDY RATES ON MANUFACTURING FIXED INVESTMENT[1]

Positive values indicate a subsidy; negative values represent a tax.

Country	1973	1980	1981
Belgium	-2.4	-2.4	-2.4
France	1.2	1.2	4.4
Germany, Fed. Rep.	-6.7	-5.5	-5 5
Italy	4.1	5.0	5 0
Japan	-3.4	-3.4	-3.4
Netherlands	-4.3	4.2	6 2
United Kingdom	9.8	10.9	13.1[2]
United States	1.3	3.3	12.8[3]

[1]Figures are calculated as a percentage of asset price. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is five percent.

[2]Calculated on the basis of the budget bill.

[3]Calculated on the basis of the Reagan Administration proposal.

The United States (assuming full implementation of the 10-5-3 system) would move to the top of the list among industrial countries. . .

Table 3

TAX SUBSIDY RATES ON NONRESIDENTIAL FIXED INVESTMENT BY ASSET GROUP, 1981[1]

Positive values indicate a subsidy; negative values represent a tax.

Country	Non-residential Buildings	Other Construction	Transport Equipment	Nonelectrical Machinery	Electrical Machinery	Other Producer Durables
Belgium	-7.0	-4.9	0 6	1.7	4.2	2.4
France	-4.9	3.3	5.1	6.8	7.2	1.8
Germany, Fed. Rep.	-16.8	-1.3	1.1	1.1	-0.3	-1.9
Italy	5.8	12.6	4 8	4.9	7.4	5 6
Japan	-11 3	-7.5	-1 8	0.8	1.1	-0.1
Netherlands	3 3	3.5	1.5	5 6	2.9	5.6
United Kingdom[2]	0 9	15 9	5.4	11 2	12.8	12.4
United States[3]	5 6	17.6	12 5	13 8	15 6	16.0

[1]Figures are calculated as a percentage of asset price. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is five percent.

[2]Calculated on the basis of the budget bill.

[3]Calculated on the basis of the Reagan Administration proposal.