TAX TREATMENT OF INTEREST AND DIVIDENDS, CHARITABLE CONTRIBUTIONS OF CERTAIN INVENTORY, AND URANIUM LITIGATION SETTLEMENT DISCOUNTS

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

AND

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1928, S. 2214 and S. 2281

MAY 7, 1982

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TAX TREATMENT OF INTEREST AND DIVIDENDS, CHARITABLE CONTRIBUTIONS OF CERTAIN INVENTORY, SETTLEMENT AND URANIUM LITIGATION SETTLEMENT DISCOUNTS

FRIDAY, MAY 7, 1982

U.S. SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, AND SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY OF THE COMMITTEE ON FINANCE,

Washington, D.C.

The subcommittees met, pursuant to notice, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Robert Packwood and Hon. John Danforth (chairmen) presiding.

Present: Senators Dole, Packwood, Danforth, and Byrd. Also present: Senator Schmitt.

[The press release announcing the hearing, background material on S. 1928, S. 2214, S. 2281, and the prepared statement of Senator Danforth follow:]

[S. 1928, 97th Congress, 1st session]

A BILL to clarify the income tax treatment of amounts realized by certain regulated public utilities in settlement of damages under contracts for the purchase of fuel

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "M.D.L. 235 Settlement Discounts Tax Act of 1981".

SEC. 2. EXCLUSION FROM INCOME AND REDUCTION OF COST.

No amount attributable to any discount or other form of price reduction on any property or services provided for under a qualified fuel settlement shall be included in gross income. For all purposes of the Internal Revenue Code of 1954, such a discount or other form of price reduction shall be excluded from the cost of the property or services to which it relates.

SEC. 3. DEFINITION.

A "qualified fuel settlement" is a settlement of, or judgment rendered in, contracts litigation involving Westinghouse Electric Corporation, which litigation was a part of M.D.L. docket numbered 235 (E.D. Va.), civil action numbered 75-0514-R (E.D. Va.), or general docket numbered 75-23978 (Pa. Ct. C.P., Allegheny County).

SEC. 4. EFFECTIVE DATE.

This Act shall apply to the taxable year in which the taxpayer obtains a qualified fuel settlement and to all subsequent taxable years.

[S. 2214, 97th Congress, 2d session]

A BILL to amend the Internal Revenue Code of 1954 to provide a partial exclusion for dividends and interest received and to eliminate the deduction for consumer interest paid or accrued

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

SECTION 1. PARTIAL EXCLUSION OF DIVIDENDS AND INTEREST

(a) IN GENERAL.—Section 116 (relating to partial exlusion of dividends received by individuals) is amended to read as follows:

"SEC. 116. PARTIAL EXCLUSION OF DIVIDENDS AND INTEREST RECEIVED BY INDIVIDUALS.

"(a) EXCLUSION FROM GROSS INCOME.—Gross income does not include the sum of the amounts received during the taxable year by an individual as—

"(1) a dividend from a domestic corporation, or

"(2) interest.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The aggregate amount excluded from the gross income of a taxpayer under subsection (a) for any taxable year shall not exceed 25 percent of the lesser of—

"(A) $2,000 ($4,000 in the case of a joint return under section 6013), or

"(B) the excess of—

"(i) the amount of interest and dividends received by such taxpayer during such taxable year, over

"(ii) the sum of—

"(I) the amount of any deduction allowable under section 62(12) to such taxpayer for the taxable year, plus

"(II) the amount of qualified interest expenses of such taxpayer for the taxable year.

"(2) TRANSITIONAL RULE.—For purposes of applying paragraph (1) to taxable years beginning in calendar year 1982, '12.5 percent' shall be substituted for '25 percent'.

"(3) CERTAIN DIVIDENDS EXCLUDED.—Subsection (a)(1) shall not apply to any dividend from a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations).

"(c) DEFINITIONS; SPECIAL RULES.—For purposes of this section—

"(1) INTEREST DEFINED.—The term 'interest' means—

"(A) interest on deposits with a bank (as defined in section 581),

"(B) amounts (whether or not designated as interest) paid, in respect of deposits, investment certificates, or withdrawable or repurchasable shares, by—

"(i) an institution which is—

"(I) a mutual savings bank, cooperative bank, domestic building and loan association, or credit union, or

"(II) any other savings or thrift institution which is chartered and supervised under Federal or State law,

the deposits or accounts in which are insured under Federal or State law or which are protected and guaranteed under State law,

"(ii) an industrial loan association or bank chartered and supervised under Federal or State law in a manner similar to a savings and loan institution,

"(C) interest on—

"(i) evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a domestic corporation in registered form, and

"(ii) to the extent provided in regulations prescribed by the Secretary, other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public,

"(D) interest on obligations of the United States, a State, or a political subdivision of a State (not excluded from gross income of the taxpayer under any other provision of law),

"(E) interest attributable to participation shares in a trust established and maintained by a corporation established pursuant to Federal law, "(F) interest paid by an insurance company under an agreement to pay interest on—

"(i) prepaid premiums,

"(ii) life insurance policy proceeds which are left on deposit with such company by a beneficiary, and

"(iii) under regulations prescribed by the Secretary, policyholder dividends left on deposit with such company.

"(2) DISTRIBUTIONS FROM REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS.—Subsection (a) shall apply with respect to any dividend from—

"(A) a regulated investment company, subject to the limitations provided in section 854(b)(2), or

"(B) real estate investment trust, subject to the limitations provided in section 857(c).

"(3) CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR EXCLUSION.—In the case of a nonresident alien individual, subsection (a) shall apply only—

"(A) in determining the tax imposed for the taxable year pursuant to section 871(b)(1) and only in respect of dividends and interest which are effectively connected with the conduct of a trade or business within the United States, or

"(B) in determining the tax imposed for the taxable year pursuant to section 877(b).

"(4) QUALIFIED INTEREST EXPENSES.—The term 'qualified interest expenses' means an amount equal to the excess of—

"(A) the amount of all interest paid or accrued within the taxable year on indebtedness incurred by a taxpayer, over

"(B) the amount of all interest paid or accrued within the taxable year on indebtedness incurred by such taxpayer in—

"(i) acquiring, constructing, reconstructing, or rehabilitating property which is primarily used as a dwelling unit (as defined in section 280A(f)(1)), or

"(ii) carrying on a trade or business of such taxpayer.".

(b) REPEAL OF PARTIAL EXCLUSION OF INTEREST PROVIDED IN ECONOMIC RECOVERY TAX ACT OF 1981.—Subsections (a) and (c) of section 302 of the Economic Recovery Tax Act of 1981 are hereby repealed.

(c) Conforming Amendments.—

(1) The table of sections for part III of subchapter B of chapter 1 is amended by inserting "and interest" after "dividends" in the item relating to section 116.

(2) The first sentence of paragraph (2) of section 265 (relating to interest) is amended by inserting after "subtitle" the following: ", or to purchase or carry obligations or shares, or to make deposits or other investments, the interest on which is described in section 116(c) to the extent such interest is excludable from gross income under section 116".

(3) Subsection (b) of section 854 (relating to other dividends) is amended—

(A) by inserting "AND TAXABLE INTEREST" in the caption after "Dividends",

(B) by striking out the caption of paragraph (1) and inserting in lieu thereof "DEDUCTION UNDER SECTION 243.—",

(C) by striking out "the exclusion under section 116 and" in paragraph (1),

(D) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively,

(E) by inserting after paragraph (1) the following new paragraph:

"(2) EXCLUSION UNDER SECTION 116.—In the case of a dividend (other than a dividend described in subsection (a)) received from a regulated investment company—

"(A) which meets the requirements of section 852(a) for the taxable year in which it paid the dividend,

"(B) the aggregate interest received by which during the taxable year is less than 75 percent of its gross income, and

"(C) the aggregate dividends received by which during the taxable year is less than 75 percent of its gross income,

then, in computing the exclusion under section 116, there shall be taken into account only that portion of the dividend which bears the same ratio to the amount of such dividend as the sum of the aggregate dividends received and aggregate interest received bears to gross income. For purposes of the preceding sentence, gross income and aggregate interest received shall each be reduced by so much of the deduction allowable by section 163 for the taxable year as does not exceed aggregate interest received for the taxable year.",

(F) by striking out "section 116(b)" in subparagraph (B) of paragraph (4) (as redesignated by subparagraph (D) of this paragraph) and inserting in lieu thereof "section 116(b)(2)",

(G) by striking out "section 116(c)" in subparagraph (B) of paragraph (4) (as so redesignated) and inserting in lieu thereof "section 116(c)(2)", and

(H) by adding at the end of paragraph (4) (as redesignated) the following new subparagraph:

"(C) The term 'aggregate interest received' includes only interest described in section 116(c)(1).".

(4) The table of sections for part I of subchapter M of chapter 1 is amended by inserting "and taxable interest" after "dividends" in the item relating to section 854.

(5) Subsection (c) of section 857 (relating to restrictions applicable to dividends received from real estate investment trusts) is amended to read as follows:

"(c) LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REAL ESTATE INVESTMENT TRUSTS.—

"(1) CAPITAL GAIN DIVIDEND.—For purposes of section 116 (relating to exclusion for dividends and interest-received by dividuals), a capital gain dividend (as defined in subsection (b)(3)(C) received from a real estate investment trust shall not be considered a dividend.

"(2) OTHER DIVIDENDS.—In the case of a dividend received from a real estate investment trust (other than a dividend described in paragraph (1)), if—

"(A) the real estate investment trust meets the requirements of this part for the taxable year during which it paid the dividend, and

"(B) the aggregate interest received by the real estate investment trust for the taxable year is less than 75 percent of its gross income,

then, in computing the exclusion under section 116, there shall be taken into account only that portion of the dividend which bears the same ratio to the amount of such dividend as aggregate interest received bears to gross income.

"(3) ADJUSTMENTS TO GROSS INCOME AND AGGREGATE INTEREST RECEIVED.—For purposes of paragraph (2)—

"(A) gross income does not include the net capital gain,

"(B) gross income and aggregate interest received shall each be reduced by so much of the deduction allowable by section 163 for the taxable year (other than for interest on mortgages on real property owned by the real estate investment trust) as does not exceed aggregate interest received for the taxable year, and

"(C) gross income shall be reduced by the sum of the taxes imposed by paragraph (4), (5), and (6) of section 857(b).

"(4) AGGREGATE INTEREST RECEIVED.—For purposes of ths subsection, the term 'aggregate interest received' means only interest described in section 116(c)(1).

"(5) NOTICE TO SHAREHOLDERS.—The amount of any distribution by a real estate investment trust which may be taken into account as a dividend for purposes of the exclusion under section 116 shall not exceed the amount so designated by the trust in a written notice to its shareholders mailed not later than 45 days after the close of its taxable year.

"(6) CROSS REFERENCE.—

"For restriction on dividends received by a corporation, see section(c)(2).".

SEC. 2. ELIMINATION OF DEDUCTION FOR CERTAIN CONSUMER INTERSET PAID OR ACCRUED.

(a) IN GENERAL.—Section 163 of the Internal Revenue Code of 1954 (relating to interest) is amended—

(1) by striking out "interest" in subsection (a) and inserting in lieu thereof "qualified interest",

(2) by redesignating subsections (b), (c), (d), and (e) as subsections (c), (d), (e), and (f), respectively,

(3) by inserting after subsection (a) the following new subsection:

"(b) QUALIFIED INTEREST DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified interest' means—

"(A) the amount of interest paid or accrued within the taxable year on indebtedness incurred in—

"(i) acquiring, constructing, reconstructing, or rehabilitating property which is primarily used as a dwelling unit (as defined in section 280A(f)(1)), "(ii) acquiring a passenger automobile (within the meaning of title V of the Motor Vehicle Information and Cost Savings Act),

"(iii) carrying on the trade or business of the taxpayer, or

"(iv) paying the higher education expenses of the taxpayer or of a dependent of the taxpayer (within the meaning of section 152), or

"(B) investment interest (as defined in subsection (e)(3)(D)).

"(2) TRANSITIONAL RULE.—

"(A) IN GENERAL.—In the case of taxable years beginning after December 31, 1981, and before January 1, 1985, the term 'qualified interest' includes, in addition to the amount of interest described in paragraph (1), an amount equal to the applicable percentage of the amount of interest other than interest described in paragraph (1) which is paid or accrued within the taxable year on indebtedness.

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

If the table year begins in:	The applicable percentage is:
1982	87.5
1983	50.0
1984	25.0

"(3) HIGHER EDUCATION EXPENSES.—For purposes of this subsection, the term 'higher education expenses' means—

"(A) tuition and fees required for the enrollment or attendance of a student at an institution of higher education (within the meaning of section 481 of 1201(a) of the Higher Education Act of 1965),

"(B) fees, books, supplies, and equipment required for courses of instruction of such student at such an institution, and

"(C) a reasonable allowance for meals and lodging for such student while so enrolled.".

(4) by striking out "For purposes of this subsection" in subsection (e)(3) (as redesignated) and inserting in lieu thereof "For purposes of this section".

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 483(f) of such Code (relating to interest on certain deferred payments) is amended by striking out "section 163(b)" and inserting in lieu thereof "section 163(c)".

(2) Subsection (b) of section 703 of such Code (relating to partnership competitions) is amended by striking out "section 163(d)" and inserting in lieu thereof "section 163(e)".

(3) Subsection (d) of section 1055 of such Code (relating to redeemable ground rents) is amended by striking out "section 163(c)" and inserting in lieu thereof "section 163(d)".

(4) Paragraph (2) of section 1255(b) of such Code (relating to gain from disposition of section 126 property) is amended by striking out "section 163(d)" and inserting in lieu thereof "section 163(e)".

SEC. 3. EFFECTIVE DATES.

(a) PARTIAL EXCLUSION OF DIVIDENDS AND INTEREST.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by section 1 shall apply with respect to taxable years beginning after December 31, 1981.

(2) REPEAL.—

(A) IN GENERAL.—The provisions of section 1(b) shall apply to taxable years beginning after December 31, 1984.

(B) APPLICATION OF CODE.—The Internal Revenue Code of 1954 shall be applied and administered as if the subsections repealed by section 1(b), and the amendments made by the subsections so repealed, had not been enacted.

(b) DEDUCTIBILITY OF INTEREST.—The amendments made by section 2 shall apply with respect to taxable years beginning after December 31, 1981.

[S. 2281, 97th Congress, 1st session]

A BILL To amend the Internal Revenue Code of 1954 to encourage contributions of computers and other sophisticated technological equipment to elementary and secondary schools

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "Technology Education Act of 1982".

SEC. 2. CHARITABLE CONTRIBUTIONS OF TECHNOLOGICAL EQUIPMENT TO PRIMARY AND SECONDARY SCHOOLS.

Subsection (e) of section 170 of the Internal Revenue Code of 1954 (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR CONTRIBUTIONS OF TECHNOLOGICAL EQUIPMENT TO PRIMARY AND SECONDARY SCHOOLS.—

"(A) LIMIT ON REDUCTION.—In the case of a qualified contribution of technological equipment, the reduction under paragraph (1)(A) shall be no greater than the amount determined under paragraph (3)(B).

"(B) QUALIFIED CONTRIBUTION OF TECHNOLOGICAL EQUIPMENT.—For purposes of this paragraph, the term 'qualified contribution of technological property' means a charitable contribution by a corporation of tangible personal property described in paragraph (1) of section 1221, but only if—

"(i) the contribution is to an educational organization which is described in subsection (b)(1)(A)(ii) of this section and which is not an institution of higher education (as defined in section 3304(f)),

"(ii) the contribution is made—

"(I) not later than 2 years after the date the construction of the property is substantially completed, and

"(II) after the date of the enactment of the Technology Education Act of 1982 and before the date 1 year after such date of enactment,

"(iii) the original use of the property is by the donee,

"(iv) the property is a computer (or other sophisticated technological equipment or apparatus) all of the use of which by the donee is directly in the education of students in the United States,

"(v) the property is not transferred by the donee in exchange for money, other property, or services, and

"(vi) the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of clauses (iv) and (v).

"(C) INCREASE IN PERCENTAGE LIMITATION.—The limitation of subsection (b)(2) shall be increased by the aggregate amount (determined after the application of this subsection) of the qualified contributions of technological property made by the taxpayer during the taxable year; except that such limitation shall not be increased to an amount greater than 30 percent of the taxpayer's taxable income (as computed for purposes of subsection (b)(2)).

"(D) CORPORATION.—For purposes of this paragraph, the term 'corporation' shall not include—

"(i) an electing small business corporation (as defined in section 1371(b)),

"(ii) a personal holding company (as defined in section 542), and

"(iii) a service organization (as defined in section 414(m)(3)).".

SEC. 3. EFFECTIVE DATE.

The amendment made by section 2 shall apply to taxable years ending after the date of the enactment of this Act

[Press Release, April 20, 1982]

Finance Subcommittees Set Hearings on the Tax Treatment of Interest and Dividends, Charitable Contributions of Certain Inventory, and Discounts Received in Settlement of Westinghouse Uranium Litigation

Senator Bob Packwood, Chairman of the Subcommitee on Taxation and Debt Management and Senator John Chafee, Chairman of the Subcommittee on Savings, Pensions, and Investment Policy, announced today that the Subcommittees will hold a joing hearing on Friday, May 7, 1982 to consider S. 2214, the Savings and Investment Incentives Act. Senator Packwood also announced that, immediately following the joint hearing on S. 2214, the Taxation and Debt Management Subcommittee will hold a hearing on S. 2281, the Technical Education Act, and S. 1928, the M.D.L. 235 Settlement Discounts Tax Act. Both Subcommittees are Subcommittees of the Senate Committee on Finance.

The hearings will begin at 9:00 a.m. in Room 2221 of the Dirksen Senate Office Building.

S. 2214, the subject of the joint hearing, was introduced by Senators Schmitt, Packwood, Symms, Grassley, and Mattingly. The bill would phase out, over 4 years, the interest paid deduction for consumer credit. Interest paid on consumer credit would not include investment interest and interest paid on home mortgages, auto loans, higher education loans, or indebtedness incurred in carrying on a trade or business. S. 2214 would also expand the partial exclusion of interest income provided in Internal Revenue Code section 128, presently effective for tax years beginning after December 31, 1984. The bill would make the partial exclusion effective for tax years beginning after December 31, 1981, increase the excluded percentage from 15 percent to 25 percent, raise the annual exclusion ceiling fom $450 for individuals and $900 for couples to $500 and $1,000, respectively, and allow dividend income to qualify for the exclusion.

S. 2281, introduced by Senator Danforth, would increase the deduction allowed for manufacturers or computers and other technological equipment when they contribute such property to primary and secondary schools. Under the bill, such manufacturers generally would be entitled to deduct one-half cf their profit, as well as their basis in the donated equipment. In addition, when such contributions are made, the bill would increase the annual charitable contribution limit from 10 percent of the contributor's taxable income to 30 percent. This bill would benefit Apple Computer Inc. and other manufacturers with adequate production capacity or inventories to make large contributions of inventory in a single tax year.

S. 1928, introduced by Senators Danforth and Harry F. Byrd, Jr., would exclude from income amounts attributable to discounts or price reductions provided under agreements settling litigation involving the Westinghouse Electric Corporation's contracts to supply uranium to 39 utilities.

Description of S. 2214

Introduction

S. 2214 (introduced by Senators Schmitt, Packwood, Symms, Grassley and Mattingly), relating to a partial exclusion for dividend and interest income in excess of certain interest expenses and to the deduction for certain types of nonbusiness interest expense, is scheduled for a joint hearing on May 7, 1982, before the Senate Finance Subcommittees on Taxation and Debt Management and on Savings, Pensions, and Investment Policy.

This document consists of a summary of the bill followed by a more detailed description which includes present law, issues, explanation of the bill, effective date, and revenue effect.

I. Summary of S. 2214

Under present law, individuals may exclude from income up to $100 ($200 on a joint return) of dividend income. Beginning in 1985, taxpayers also will be able to exclude 15 percent of up to $3,000 ($6,000 on a joint return) of interest income in excess of all allowable interest deductions, other than interest incurred in acquiring or rehabilitating a dwelling unit or in carrying on a trade or business. The maximum exclusion of interest income thus will be $450 ($900 on a joint return). Also under present law, a deduction is allowed for interest paid on indebtedness, except that the deduction for interest on indebtedness incurred to purchase or carry investments is limited.

Under the bill, the dividend and interest exlusions in present law would be replaced with an exclusion of 25 percent of up to $2,000 ($4,000 on a joint return) of dividend and interest income in excess of all allowable interest deductions, other than interest incurred in acquiring or rehabilitating a dwelling unit or in carrying on a trade or business. The maximum exclusion of dividend and interest income thus would be $500 ($1,000 on a joint return). Also, under the bill, the deduction for interest paid would be allowed only for interest incurred in connection with a trade or business, investments, acquiring or rehabilitating a dwelling unit, acquiring a passenger automobile, and expenses for higher education. The deduction for other types of interest expense would be phased out over a four-year period.

II. DESCRIPTION OF S. 2214

Present law—dividend and interest exclusions.

Under present law, individuals may exclude from gross income up to $100 ($200 on a joint return) of dividend income from domestic sources. In addition, taxpayers may exclude up to $1,000 ($2,000 on a joint return) of interest income earned on qualified savings certificates (sometimes referred to as "All-Savers" certificates) issued before January 1, 1983, by commercial banks, thrift institutions, or credit unions.

Beginning in 1985, taxpayers will be able to exclude 15 percent of up to $3,000 of net interest ($6,000 on a joint return). Thus, the maximum exclusion will be $450 ($900 on a joint return). Net interest generally is defined as interest income received by the taxpayer reduced by any forfeitures due to early withdrawals and any interest expenses paid or incurred during the year other than interest incurred (1) in acquiring, constructing, reconstructing or rehabilitating a dwelling unit or (2) in carrying on a trade or business.[1]

Interest income eligible for the exclusion generally includes interest on (1) bank deposits; (2) insured deposits and share accounts in mutual savings banks, credit unions, and other savings or thrift institutions chartered under Federal or State law; (3) bonds, debentures, and certain other debt instruments of U.S. corporations; (4) U.S. obligations or obligations of State or local governments (unless the interest is excludable from gross income); (5) shares in a trust maintained by a corporation established under Federal law (e.g., the Government National Mortgage Association); and (6) prepaid premiums or life insurance proceeds left on deposit with an insurance company.

Interest paid deduction

Under present law, taxpayers may deduct amounts paid or incurred as interest on indebtedness. In the case of interest paid in connection with a trade or business or attributable to property held for the production of rents and royalties, the deduction is taken in computing adjusted gross income and thus is allowable whether or not an individual itemizes deductions. Other interest expense is allowable only as an itemized deduction.

A limit applies to an individual's deduction for investment interest, i.e., interest on amounts borrowed to acquire or carry property held for investment. This limit generally is the individual's net investment income for the year plus $10,000 ($5,000 for a married taxpayer filing a separate return). Investment income includes dividends, interest, rents, royalties and net short-term capital gain attributable to the disposition of investment property, but does not include amounts derived from conducting a trade or business. Before applying the limitation, investment income must first be reduced by expenses (other than interest) directly connected with its production. In addition, certain property subjects to a net lease is treated as investment property, and the otherwise applicable deduction limit is increased to the extent certain expenses exceed rental income from the lease. Disallowed investment interest is carried forward to succeeding taxable years subject to the limitation on the deduction in the carryforward year.

[1] H.R. 6056, The Technical Corrections Act of 1982, would clarify that an individual who does not itemize deductions would not be required to reduce interest income eligible for the exclusion by interest expense, and that a person itemizing deductions would be required to reduce such interest income by no more than the amount of his or her excess itemized deductions. The bill would also provide that for the purposes of determining the amount of other exclusions, itemized deductions, and credits, adjusted gross income would not be reduced by the amount of the net interest exclusion.

Issues

The bill raises two general issues: (1) whether, in place of the present law dividend and net interest exclusions, an individual should be permitted an exclusion from income equal to 25 percent of the excess of dividend and interest income over certain types of deductible interest expenses, and (2) whether the deduction for interest paid should be limited to interest expenses incurred in connection with a trade or business, investments, housing, automobiles and educational expenses.

Explanation of the bill

a. Partial exclusion of dividends and interest:

Under the bill, the present law dividend exclusion and net interest exclusion would be repealed. Instead, individuals could exclude from income 25 percent of their net interest and dividend income up to $2,000 ($4,000 on a joint return). Thus, taxpayers could exclude up to $500 ($1,000 on a joint return) of net dividend and interest income in any year. Net interest and dividend income would be the amount of interest and dividends received by the taxpayers reduced by any forfeitures due to early withdrawals and any interest expenses paid or incurred during the year other than interest incurred (1) in acquiring, constructing, reconstructing or rehabilitating a dwelling unit or (2) in carrying on a trade or business.

This provision would be fully effective for interest and dividends received in taxable years beginning after 1982. For interest and dividends received in 1982, a 12.5-percent exclusion would be available.

Interest and dividends eligible for exclusion under the bill would be the same items eligible for the present dividend and 15-percent net interest exclusions.

b. Elimination of deduction for certain interest:

Under the bill, a deduction would be allowed only for certain types of interest ("qualified interest"). These would include interest incurred in (1) carrying on a trade or business, (2) acquiring or carrying property held for investment, (3) acquiring, constructing, reconstructing or rehabilitating a dwelling unit, (4) acquiring a passenger automobile, and (5) paying higher education expenses of the taxpayer or his dependent. The present limit on the deduction for investment interest would be retained.

Higher education expenses would be defined as (1) tuition and fees required for a student's enrollment or attendance at an institution of higher education; (2) fees, books, supplies and equipment required by the student for a course of instruction at the institution; and (3) a reasonable allowance for the student's meals and lodging. For this purpose, institutions of higher education include accredited universities and colleges, junior colleges, and post-secondary technical and training schools.

Under the bill, denial of the deduction for interest that is not qualified interest would be phased in. For 1982, 87½ percent of the nonqualified interest paid or incurred by the taxpayer within the year would be deductible. For 1983, a deduction would be allowed for 50 percent of nonqualified interest. For 1984, the applicable percentage would be 25. For taxable years beginning after 1984, only qualified interest would be eligible for the deduction.

Effective date

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

Revenue effect

It is estimated that the bill would reduce fiscal year receipts by $160 million in 1982 and $755 million in 1983, and would increase fiscal year receipts by $290 million in 1984, $2,876 million in 1985, $5,898 million in 1986, and $6,305 million in 1987.

Description of Tax Bills—S. 1928 and S. 2281

INTRODUCTION

The bills described in this document have been scheduled for a public hearing on May 7, 1982, before the Senate Finance Subcommittee on Taxation and Debt Management.

There are two bills scheduled for the hearing: S. 1928, relating to amounts received in settlement of Westinghouse uranium litigation, and S. 2281, relating to special one-year rules for charitable contributions of technological equipment to primary and secondary schools for use in educating students.

The first part of the document is a summary of the bills. (The bills are presented in the document in the same order as listed in the press release announcing the hearing.) This is followed by a more detailed description of each bill, including present law, issues, explanation of the bill, and effective date.

I. SUMMARY

1. S. 2281—Senators Danforth and Cranston: Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools.

Present law

Under present law, the amount of charitable deduction allowed for a contribution of ordinary-income property (such as a donation of inventory by a manufacturer) is limited, subject to certain exceptions, to the donor's cost basis in the property (Code sec. 170(e)). Also under present law, the maximum charitable deduction allowed to a corporation in one year for the total amount of its contributions is 10 percent of the corporation's taxable income for the year, with a five-year carryover of any excess. (This limitation was raised from five percent by the Economic Recovery Tax Act of 1981.)

Explanation of the bill

The bill would provide special rules for a charitable contribution by a corporation of a computer, or other sophisticated technological equipment, to a primary or secondary school for use directly in the education of students.

Under the bill, a deduction would be allowed for the sum of the donor's cost basis in the property plus 50 percent of the difference between the property's fair market value and basis, but not to exceed twice the basis. Also, the bill would increase, to up to 30 percent of taxable income, the limitation on the aggregate amount deductible in one year by a corporate donor which makes such contributions.

The special charitable deduction rules under the bill would apply to qualifying donations of computers or other sophisticated technological equipment only if made within one year after enactment of the bill.

2. S. 1928—Senators Danforth, Byrd (of Va.), and Kassebaum: Amounts Received in Settlement of Westinghouse Uranium Litigation.

Background

In 1979, Westinghouse Electric Corporation agreed to settle litigation with several electric utilities involving contracts to sell nuclear fuel. Under the terms of the settlements, Westinghouse agreed to provide immediate cash payments and future price discounts on the purchase of nuclear fuel and other goods and services. In exchange, Westinghouse was relieved of its obligation to provide nuclear fuel at the price it had contracted for in the late 1960s and early 1970s.

Explanation of the bill

The bill would provide that a utility would not include any amount in income for discounts or price reductions provided pursuant to its settlement with Westinghouse. Any price reduction under the settlement would be excluded from the cost of the goods or services to which the reduction relates; thus, for example, any amount of investment credit or depreciation allowance would be based on the utility's cost after taking into account any reduction provided under the settlement.

The provisions of the bill would be effective for the taxable year in which the taxpayer obtained its settlement with Westinghouse and for all subsequent taxable years.

II. DESCRIPTION OF BILLS

1. S. 2281—Senators Danforth and Cranston: Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools.

Present law—General reduction rule

A taxpayer generally may deduct, within certain limitations, the amount of cash or the fair market value of other property contributed to qualified charitable organizations. However, the amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)).[1] Thus, a donor of appreciated ordinary-

[1] In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the do-

Continued

income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than the fair market value. For example, a manufacturer which donates a product from its inventory generally may deduct only its inventory cost for the item.

Exceptions

Under present law, charitable contributions by corporations of two types of ordinary-income property, if donated to certain exempt organizations for specified purposes, are subject to a different reduction rule.

The first exception, enacted in the Tax Reform Act of 1976, is for corporate donations of ordinary-income property to a charitable organization to be used solely for care of the needy, the ill, or infants (such as donations by the producer or manufacturer of food, clothing, or medical equipment), where such use is related to the donee's charitable functions (sec. 170(e)(3)).

The second exception, enacted in the Economic Recovery Tax Act of 1981, is for corporate donations of newly constructed scientific equipment to a college or university to be used for research (or research training) in the United States in the physical or biological sciences (sec. 170(e)(4)).

In the case of a charitable contribution of inventory which qualifies under one of these exceptions, the corporate donor generally is allowed a deduction equal to the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., the difference between fair market value and basis). However, in no event is a deduction allowed for an amount in excess of twice the basis of the property (sec. 170(e)(3)(B)).

These two exceptions were enacted because the Congress concluded that it was desirable to provide a greater tax incentive than would be available if the general reduction rule applied for charitable contributions of certain types of ordinary-income property for particular purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Overall deduction limitation

The total charitable deduction allowed to a corporation is limited to 10 percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. (This limitation was raised from five percent by the Economic Recovery Tax Act of 1981.) If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

Issues

1. The first issue is whether contributions by businesses to schools for use in educating students where there might be a benefit to the donor (e.g., through increasing a market for the business' products) should be treated for income tax purposes as charitable contributions (in which case a charitable deduction may be allowed for an amount in excess of the cost basis of the donated item), or as noncharitable promotional expenditures (in which case the deduction would be limited to the item's cost to the donor).[2]

2. If such contributions are to be treated as charitable contributions, the second principal issue is whether an exception to the general reduction rule applicable to charitable contributions of inventory should be made in the case of qualifying contributions of computers, etc.; i.e., should any deduction in excess of the cost of the goods to the donor be allowed, and if so, how much. Related issues are (a) what kinds of property should be eligible for any special treatment (for example, should

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nated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

[2] In *Singer Co.* v. *U.S.*, the U.S. Court of Claims upheld IRS denial of charitable deductions claimed by a manufacturer for the amount of discounts allowed on purchases of sewing machines by schools and colleges (449 F.2d 413) (Ct. Cl. 1971)).

In that case, the court had found that the school discounts were offered "for the predominant purpose of encouraging [the schools] to interest and train young women in the art of machine sewing, thereby enlarging the future potential market by developing prospective purchasers of home sewing machines and, more particularly, Singer machines—the brand on which the future buyers learned to sew." The court concluded that the manufacturer's predominant reason for granting such discounts was other than charitable, notwithstanding that the company said it would have provided the discounts even if it had a total monopoly of the sewing machine market, and even though a company survey showed that fewer than two percent of its regular retail customers had been influenced in buying by previous school training. Since the company expected a return in the nature of future increased sales, the court concluded that the company received a *quid pro quo* for the discounts which was substantial and was therefore inconsistent with allowing charitable deductions.

all types of sophisticated technological equipment be eligible or only computers, and if so limited, how qualifying computers should be defined); and (b) whether any special treatment should be accorded to all taxpayers, or limited (for example) to manufacturers.

3. The third, principal issue is whether, in the case of such contributions, the limitation on the aggregate charitable deduction allowed in one year to a corporation should be increased above the general 10 percent limitation.

Explanation of the bill—Overview

The bill would provide a larger charitable deduction (than would be allowed under the general reduction rule), and would increase the general limitation on the aggregate amount of corporate contributions deductible in a year, for charitable contributions by corporations of computers or other sophisticated technological equipment, if contributed to a primary or secondary school, and if used by the school directly in the education of students. These special charitable deduction provisions would apply only to qualifying donations which are made within one year after enactment of the bill.

The principal intended beneficiary of the bill is Apple Computer, Inc. The provisions of the bill would also benefit any other corporate taxpayer which, during the one-year period following enactment of the bill, makes qualifying charitable contributions of computers or other sophisticated technological equipment.

Requirements for favorable treatment

In order for the special deduction rules of the bill to apply, there must be a charitable contribution (as defined under sec. 170(c)) by a corporation [3] which satisfies the following requirements:

(1) The donated property is a computer or other sophisticated technological equipment or apparatus, and is of an inventory nature (within the meaning of sec. 1221(1));

(2) The property is donated to an educational organization (described in sec. 170(b)(1)(A)(ii)) [4] other than an institution of higher education (as defined in sec. 3304(f)); [5]

(3) The contribution is made within two years of substantial completion of construction of the property, and within one year after the enactment of the bill;

(4) The original use of the donated property is by the school;

(5) All the use of the donated property by the school is directly in the education of students in the United States;

(6) The donated property is not transferred by the school in exchange for money, other property, or services; and

(7) The donor receives a written statement from the school representing that the use and disposition of the donated property will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction allowed by the bill generally would be for the sum of (1) the taxpayer's basis in the property, plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event would a deduction be allowed for any amount in excess of twice the basis of the property.

For example, if a manufacturer makes a qualifying contribution to a high school of a computer with a cost basis of $5*X*, and a fair market value of $16*X*, the bill

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[3] The bill would not apply in the case of a corporation which is a subchapter S corporation (as defined in sec. 1371(b)); a personal holding company (as defined in sec. 542); or a service organization (as defined in sec. 414(m)(3)).

[4] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, * * *" and includes both public and private schools (Reg. § 1.170A-9(b)(1)).

[5] An institution of higher education, as defined in sec. 3304(f), means an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

would allow the manufacturer a charitable deduction of $10X (twice the $5X basis). Assuming a 46 percent tax bracket, the effect of the deduction under the bill would be to reduce the manufacturer's tax liability by $4.6X, or 92 percent of the cost of manufacture. The out-of-pocket cost of the donation to the manufacturer, exclusive of distribution and other expenses, would then be $0.4X. If in the example the fair market value of the computer was $11X, the deduction would be $8X ($5X basis plus ½ of the $6X difference between value and basis), and the out-of-pocket cost to the manufacturer would be $1.32X ($5X cost less $3.68X tax benefit).

Increased overall limitation

The bill also would provide that the limitation on the aggregate charitable contribution deduction allowed to a corporation (under present law, 10 percent of taxable income, computed with certain adjustments) would be increased by the amount of the taxpayer's qualifying contributions of computers or other sophisticated technological equipment. However, the limit as so increased could not exceed 30 percent of taxable income (as computed with certain adjustments).

Effective date

The provisions of the bill would apply to taxable years ending after the date of enactment. The special deduction rules provided under the bill would apply only to qualifying contributions which are made within one year after enactment.

2. S. 1928—Senators Danforth, Byrd (of Va.), and Kassebaum: Amounts Received in Settlement of Westinghouse Uranium Litigation.

Background

During the late 1960s and early 1970s, electric utilities throughout the country entered into contracts with Westinghouse Electric Corporation to purchase nuclear fuel at an average contract price of about $8–$10 per pound of uranium. Westinghouse planned to fulfill its contract obligations through its own production and by purchases from other sources. However, when the market price for uranium rose to more than $25 per pound in 1975, Westinghouse refused to deliver uranium at the contract price, arguing that it was excused from its contractual obligations by reason of commercial impracticability. This action by Westinghouse gave rise to court suits which were settled in 1979, by which time the price of uranium had increased to over $40 per pound.

Under the terms of the settlements with electric utilities, Westinghouse agreed to provide cash payments, a future supply of uranium at prices higher than the original contract price but less than market prices, plus other goods and services at discounted prices. The total settlement benefits are estimated to exceed $1.8 billion and will be received by the utilities over a period as long as 28 years from the year of the settlement.

Present law

In a private letter ruling (LTR 8134189), the Internal Revenue Service has taken the position that the settlements constitute taxable events, generally resulting in taxation to the utilities (in the year of the settlement) of the present value of the settlement benefits. For accrual-basis taxpayers, the Service's position is that damages for breach of contract are includible in income for the year in which the settlement is reached.

The correctness of the Service's letter ruling is disputed in part by the utilities. It has been argued by some that the payment of cash is the only taxable event under the Westinghouse settlement, and that establishing the right to receive future discounts on purchases should be viewed as analogous to a nontaxable adjustment of contract terms. Thus, it is argued that price discounts on nuclear fuel or other goods and services resulting from the settlement should be treated as having the same tax consequences as changed prices resulting from renegotiated contracts.

Issue

The issue is whether the present value of future price discounts on nuclear fuel and other goods and services that Westinghouse has agreed to provide in settlement of its litigation with electric utilities should be included in the income of the utilities for the year of the settlement.

Explanation of the bill

Under the bill, no amount would be included in the income of a utility by reason of discounts or price reductions to be provided by Westinghouse Electric Corporation in settlement of the litigation of Westinghouse's contractual obligation to provide nuclear fuel to the utility. For purposes of determining investment credits, depreciation allowances, deductions for business expenses, etc., the utility's cost for the

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goods or services is the cost as reduced by the price discounts or reductions. The bill would not affect the tax consequences of any cash payments by Westinghouse to utilities under the settlement.

The bill does not provide any special rule for determining the taxable year for which deductions, if any, are allowable to Westinghouse with respect to the settlement.

Effective date

The provisions of the bill would apply to the taxable year in which the taxpayer obtained its settlement with Westinghouse and to all subsequent taxable years.

Senator PACKWOOD. The committee will come to order.

We are here today to hear three bills. We will follow the usual practice of holding the witnesses to 5 minutes. Their entire statements will be placed in the record. The exception, of course, for that is the Treasury Department who has to comment on all of the bills that we have before us.

Before we start with the witnesses, however, I would like to thank Senator Schmitt personally. He was the one that first introduced me to this bill and asked me to cosponsor it, and after reading it I did. I think it is an excellent bill. Anything that will tilt us toward capital formation and away from consumption I regard as a tilt in the right direction. And this bill certainly does tilt in that direction.

I am doubly pleased to have Senator Schmitt here today, away from his other duties. As you know, he is not a member of the Finance Committee, so we are doubly pleased, Jack, that you would take the time to come. I know he has an opening statement.

Senator Schmitt.

STATEMENT OF HON. HARRISON H. SCHMITT, U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator SCHMITT. Thank you, Mr. Chairman. I greatly appreciate this opportunity to testify before my old committee. As a freshman, I was a member of the Finance Committee for 1 month, and it's great to be back—and back for what I think is an extremely important cause.

I am also honored that you have joined as a cosponsor of this legislation, along with Senator Symms, Senator Grassley, and Senator Wallop of this committee.

As you have indicated, one of the fundamental—if not the most fundamental—current problems in our economy has to do with the availability of capital and the consequential shortage of capital associated with high interest rates.

There really are two fundamental generic reasons why we have high interest rates. One, the American people are unwilling to invest or save their money at interest rates that are significantly below the inflation level of just a few years ago; and, two, there is a shortage of that commodity which we call money.

This bill can't do much about the propensity of the American people to accept lower interest rates; only controlling inflation for a significant period of time can accomplish that. But this bill can deal with the other part of the problem by increasing the supply of capital and by decreasing the propensity to consume relative to that.

In brief, S. 2214 would accomplish the following:

First, it would create an effective incentive for the public to increase their level of saving and investment;

Second, it would increase the flow of funds into our financial institutions, thereby relieving some of the pressure on interest rates; and

Third, it would limit consumer interest deductions—a longstanding disincentive to save—and produce at least $15 billion in new Federal revenue over a 5-year period.

Mr. Chairman, it is common knowledge that the United States has a Tax Code which discriminates against saving and encourages debt by taxing interest and dividend income at the highest marginal tax rate. In some cases, as with dividends, the Tax Code allows a double taxation mode while it provides for a full deductibility of interest expenses.

The falling savings rate of the American public during the past decade features prominently in the story of the declining performance of the U.S. economy. Personal savings as a percentage of disposable income has undergone a steady decline from 8.6 percent in 1973 to 5.3 percent in February of this year. In almost every year since 1973 the amount of personal savings has progressively contracted. The overall reduction is in excess of 35 percent. Moreover, despite the major incentives that were put into the Tax Code last year concerning direct incentives to save and invest, we have continued to see a decline in our savings rate.

I would point out that in spite of the existence of an expanded IRA, the lower tax rates that went into effect in October, and the existence of the all-savers certificate, the savings rate has actually declined from the 6.1-percent level posted during the 4th quarter of last year.

In brief, Mr. Chairman, the stakes are very high. Continued inflationary expectations and high interest rates are wreaking havoc in our economy, and we cannot afford to take the chance that the savings rate may or may not increase in the future.

S. 2214 amends the net interest provision of existing law in five ways.

First, the bill increases the percentage exclusion from 15 to 25 percent.

I should mention here, Mr. Chairman, that we have a provision related to this concept in current law as the result of decisions made last year in the Tax Code. Unfortunately, that provision does not take effect until 1985 and is limited in its effect even at that time. As I stated previously, the bill will revise that situation by increasing the percentage exclusion from 15 to 25 percent.

Secondly, it expands the ceiling on the amount that can be considered tax-free from $450 for individuals and $900 for couples to $500 and $1,000, respectively.

Third, S. 2214 makes dividend income eligible for the percentage exclusion.

Fourth, it advances the effective date from January 1, 1985, to July 1 of this year.

Fifth, and finally, it places limits on the deductibility of consumer interest expense by gradually phasing out that deductibility over a 4-year period.

Now let me explain the rationale for each of these elements of the bill.

The percentage exclusion approach to tax incentives for savings is conceptually similar to that accorded to capital gains. The primary virtue of this approach is that it affects nearly all taxpayers, not merely a select few—as with many savings-incentive proposals. Many of the so-called savings-incentive proposals before the Congress are flawed because they provide no means of calculating net interest income. Under a net-interest approach, certain interest expenses are subtracted from interest income and arrive at the taxpayer's net income. Conceptually, the net interest idea is designed to reward the individual who is on a net basis adding to his and the national pool of capital rather than the individual who merely borrows and saves equal amounts.

The fact that our Nation's rate of personal savings is dangerously low and continues to fall exacerbates the need for decisive incentives that will impact on savings in the immediate future. By advancing the effective date of percentage exclusion to July 1, 1982, savers can realize the benefits of adding to their savings within this taxable year.

Mr. Chairman, investment in our Nation's industry is as important to our economic recovery as increasing the national pool of savings. Currently, investors are burdened with a heavy double taxation of their dividend income because such income is taxed first at the corporate level and once again when it is received by the individual. Further, dividends are not eligible for capital gains treatment, so they are taxed at the highest marginal rate. This bill would begin the process of changing that situation

In addition, Mr. Chairman, the need for a tax stimulus for savings is well established. But how to pay for such an incentive? I can think of no better means for raising the necessary revenues than by gradually phasing out the consumer interest deduction, which in itself represents a disincentive to save.

The deduction for consumer interest has been included as a special allowance in the tax expenditure budget since its inception, I believe, back in 1913. A number of expert commentators on our tax system agree that no such justification can be made for consumer interest deductions. Milton Friedman, the Nobel Prize winning economist, argues that it represents a subsidy for borrowing that should be eliminated. George Breek and Joseph Peckman of the Brookings Institution argue that the deduction for interest on consumer loans is clearly a subsidy to those who borrow for current consumption.

Mr. Chairman, beyond the convincing nature of these arguments, it is interesting to note that they span the political spectrum from Milton Friedman to Joseph Peckman, from the Brookings Institution to the American Enterprise Institute. Thus, there exists general agreement on this issue that consumer interest deduction does not make sense and in fact is regressive. It is available only to those people who itemize their deductions on their income tax forms. If they do not itemize, then they get no benefit from this deduction. As you know, only 25 percent or so of the American people itemize.

As previously mentioned, the dollar benefit to higher income individuals is much more pronounced than the benefit for lower income individuals because higher income individuals have higher marginal tax rates. Thus, individuals in the over-$50,000 class of income may be subject to a 50-percent tax rate and thereby save half of their $3,076 deduction. An individual in the $20,000 income bracket and below may be subject to a 14-percent rate, which on his $46 average deduction will save a paltry $6.

Mr. Chairman, S. 2214 would create a solid, well thought-out method of encouraging the public to save and invest more in our economy, and it would do this at no cost to the Treasury. On the contrary, as the tables in my prepared testimony indicate, it would produce at least $15 billion in revenues over a 5-year period—according to the analysis of the Joint Tax Committee of the Congress.

Mr. Chairman, it is clear that in the past the United States has unintentionally created a tax system that is heavily weighted in favor of debt and consumption and against savings and investment. This bill is intended as a complement to steps already enacted to correct the weighted scales. Furthermore, it is designed to insure that the hoped-for increases in savings and investment in our economy—as the result of past actions—will, in fact, occur.

I thank the chairman and the committee for their consideration of this bill, and I will look forward to hearing the testimony on it.

Senator PACKWOOD. Jack, thank you. And, again, my appreciation for your thinking up and calling for cosponsorship in introducing this bill.

[The prepared statement follows:]

STATEMENT OF

SENATOR HARRISON SCHMITT

Mr. Chairman, I greatly appreciate the opportunity to testify before your Subcommittee, and that of Senator Chafee's, on S. 2214, the Savings and Investment Incentives Act. I am also honored that you have joined as a cosponsor of this legislation -- along with Senator Symms, Senator Grassley and Senator Wallop of the Finance Committee.

In brief, S. 2214 would accomplish the following:

One - Create an effective incentive for the public to increase their level of saving and investment.

Two - Increase the flow of funds into our financial institutions, relieving some of the pressure on interest rates.

Three - Limit the consumer interest deduction - a long standing disincentive to save - and produce at least $15 billion in new Federal revenue over a five year period.

It is common knowledge that the United States has a tax code which discriminates against saving and encourages debt by taxing interest and dividend income at the highest marginal tax rate, while providing for the full deductibility of interest expenses.

A significant factor in the declining performance of the U.S. economy in the past decade has been falling rates of saving by the American public. Personal savings as a percentage of disposable personal income has undergone a steady decline from 8.6 percent in 1973 to 5.3 percent in February of this year. In almost every year since 1973, the amount of personal savings has fallen lower than the previous year. The overall reduction is in excess of 35 percent.

Our low rate of savings plays a role in forcing interest rates upward. Interest rates are the price of money, and like any other commodity they move in accord with the forces of supply and demand. The source of our current high interest rates can be traced directly to the existence of excessive demands for credit by government, business and individuals who compete with one another in the financial markets. Coupled with a limited supply of capital which results in part from our low rate of personal savings, excessive demand has led to sustained high levels of interest rates in spite of currently low and decreasing inflation.

In short, we have an economy that saves only five percent to six percent of GNP (including both individual and business saving), yet which tries to borrow fifteen percent of GNP. We see the results of this situation in the homebuilding industry, in the condition of our thrift institutions, in the farming community and with the rising number of bankruptcies in businesses of all types. One aspect of an interest rate problem is frequently overlooked -- and that is the need to expand the supply of credit. This can only be accomplished if Americans increase their rate of savings.

I might point out in passing that both Japan and Germany have had, in recent years, Federal deficits which as a percentage of GNP are in excess of ours here in the U.S. Further, interest rates in these countries have generally been substantially lower than ours. How is this accomplished? The higher rates of personal savings in these countries increases the supply of credit in the system, balancing the effects of higher rates of government borrowing. If we are to weather the storm of current and impending Federal deficits, without renewed pressure on interest rates that could be devastating to our economy, it is generally agreed by both the Administration and outside economists that personal savings must increase.

There are those who believe that savings rates will increase as a result of changes in tax law already made. These very laudable changes include dropping the top rate from 70 to 50 percent and the expansion of IRA accounts. While I support these provisions, I believe their effects on the U.S. rate of personal savings are open to question.

I would point out that in spite of the existence of the expanded IRA, the lower tax rates that went into effect in October and the existence of the All Savers Certificate, the savings rate has actually declined from the 6.1 percent level of the fourth quarter. In brief, Mr. Chairman, the stakes are very high. Continued inflationary expectations and high interest rates are wreaking havoc on our economy and we cannot afford to take the chance that savings may or may not increase in the future.

S. 2214, the Savings and Investment Incentives Act of 1982, is designed to insure that increased levels of savings and investment do, in fact, take place. As you know the Economic Recovery Tax Act of 1981 provides for 15 percent of net interest income to be tax exempt, effective January 1, 1985. This provision was agreed to on the floor by the full Senate and was endorsed by the Administration as a conceptually sound approach to savings incentives. The House of Representatives also agreed to the provision in their bill. I regret, however, that during the compromising process in Conference the effective date was put off so far into the future. One of the purposes of this bill is, of course, to move that date up.

The percentage exclusion of net interest enjoys broad support from within the Congress and among the economic community. Martin Feldstein, of Harvard University, has endorsed the concept on several occasions, other experts on tax law, two of whom you will hear from today, have also spoken highly of the proposal.

I believe that the urgent need for a stimulus to increase saving and investment, coupled with the strong support for S. 2214 within the Congress, strongly argues for favorable action on the bill in the current session.

S. 2214 amends the net interest provision of existing law in five ways.

- First, S. 2214 increases the percentage exclusion from 15 to 25 percent.

- Second, it expands the ceiling on the amount that can be considered tax free from $450 for individuals and $900 for couples to $500 and $1000 respectively.

- Third, S. 2214 makes dividend income eligible for the percentage exclusion.

-Fourth, it advances the effective date from January 1, 1985 to July 1 of this year.

- Fifth, it places limits on the deductibility of consumer interest expense.

Let me explain the rationale for each of these elements of the bill.

PERCENTAGE EXCLUSION

The percentage exclusion approach to tax incentives for savings is conceptually similar to that accorded to capital gains. The primary virtue of this approach is that it affects nearly all taxpayers -- not merely a select few, as with many savings incentive proposals. For example, in 1981 the first $200 in interest earned by an individual was exempt from tax -- but this provides no incentive to earn the $201st dollar of interest income! Since 80% of the interest in our economy is earned by those with more than $1,000 per year of such income, even a $1,000 exclusion will have a limited affect -- and will be extremely expensive. I would draw your attention to Table I in the appendix to my statement which shows the distribution of interest income throughout the population.

How much more simple, and effective, it is to make 25% of each interest dollar tax exempt. This way every taxpayer has an incentive to earn an additional dollar of interest income, knowing that it will be eligible for tax benefit.

I realize that there is a ceiling in the bill on the amount to which the 25 percent exclusion would apply of $2000 for individuals and $4000 for married couples. This is more to limit revenue loss than for any policy purpose. It would be my hope that the ceiling can be raised substantially and perhaps eliminated in future years.

NET INTEREST

Many of the so-called saving incentive proposals before the Congress are flawed because they provide for no means of calculating net interest income. Under many of these proposals the taxpayer could simply borrow $10,000 from bank A, deposit it in bank B, pay the interest expense to the first bank, earn the interest income from the second, and derive a profit from the transaction based on some tax benefit provided to the interest income earned. This process, known as arbitrage, is not really savings. Under a net interest approach, certain interest expenses are subtracted from interest income to arrive at the taxpayer's net interest income. Conceptually, the net interest idea is designed to reward the individual who is, on a net basis, adding to the national pool of capital, rather than the individual who merely borrows and saves in equal amounts.

ADVANCEMENT OF THE EFFECTIVE DATE

The fact that our nation's rate of personal savings is dangerously low and continues to fall exacerbates the need for decisive incentives that will impact on savings in the immediate future. By advancing the date to July 1, 1982, savers can realize the benefits of adding to their savings within this taxable year.

If interest rates are to be brought under control, the pool of savings must grow by more than the Federal deficit, or future Federal borrowing will put even greater pressure on interest rates. We need immediate action to stimulate greater flows of funds into our nation's capital markets and financial institutions if further interest rate increases are to be forestalled.

DIVIDEND ELIGIBILITY

Investment in our nation's industry is as important to our economic recovery as increasing the national pool of savings. Currently, investors are burdened with heavy double taxation of their dividend income because such income is taxed first at the corporate level and once again when it is received by the individual. Further, dividends are not eligible for capital gains treatment, so that they are taxed at the highest marginal rate. In addition, many taxpayers invest in stocks for the income stream derived from dividends in much the same way that one might purchase a CD or a T bill; this argues strongly for equivalent treatment between interest and dividend income.

LIMITATION ON THE CONSUMER INTEREST DEDUCTION

Mr. Chairman, the need for a tax stimulus for savings is well established; the question arises of how to pay for such an incentive. I can think of no better means of raising the necessary revenues than by gradually phasing out the consumer interest deduction which, in itself, represents a disincentive to save.

One of the most curious aspects of the Federal tax code is that it provides for taxpayers to deduct consumer interest expenses. Sound economic arguments can be advanced for the deductibility of investment interest expense, but convincing arguments in support of consumer interest deductibility are few and far between.

The policy expressed in S. 2214 can be simply stated: "No deductions for consumption." It is worth noting in this regard that the interest deduction provision of the Code was not enacted with the subsidization of consumer borrowing in mind.

Provisions allowing for the deductibility of interest stem from the original 1913 income tax statute. The original statute did not, however, distinguish between business and personal interest. The Tax Expenditures compendium issued by the Senate Budget Committee makes the following observations on the rationale for the consumer interest deduction:

> "While the 1862 income tax statute did not contain a special provision for the deduction of interest, it was allowed. When the income tax was reinstituted in 1913,

a special provision allowing the deduction of interest was included, apparently because of concern that interest might not be treated as a business expense and deducted under the general business expense provision. At that time, no distinction was drawn between business and non-business interest expense, presumably because the latter constituted a very small portion of interest expense." 1/

The legislative history of the 1913 Act is largely silent on the rationale for many types of deductions, including interest. In Congressional debates on the Civil War income tax, however, the point is made on several occasions that the deduction of interest is necessary to measure income, but references were always with respect to business or investment interest. These debates were generally resolved by presuming that interest would be allowed as a deductible expense under regulation, and this was the case. 2/ Consumer interest expense at that time, however, was virtually non-existent.

The 1913 Act relied much more on statute for measuring deductions as contrasted with the Civil War income tax. It seems doubtful, however, that the widespread use of consumer debt could be envisioned at that time. It was, in fact, only with the rapid growth in consumer borrowing in the 1950's and 1960's that this deduction began to produce major revenue losses to the Treasury. I believe it is appropriate to view this provision as an unintended loophole that has only come to light in the last 30 years as consumer borrowing has grown from relatively nominal amounts in the immediate post war period to $336 billion in 1981.

THE CONSUMER INTEREST DEDUCTION IS NOT JUSTIFIED

The deduction for consumer interest has been included as a "special" allowance in the tax expenditure budget since its inception. Many tax analysts regard some of the special provisions as desirable to adjust for families' capacity to pay taxes. For example, the deduction for extraordinary medical expenses is widely held to be desirable on grounds of hardship. A number of expert commentators on our tax system agree that no such justification can be made for consumer interest deductions, however.

Milton Friedman, nobel prize winning economist, argues that it represents a subsidy for borrowing that should be eliminated.

Rudy Penner, of the American Enterprize Institute, has taken the position that it is a very big borrowing incentive for the itemizing taxpayer, which is fundamentally inconsistent with the idea of savings incentives. In addition, Penner argues that it opens the door for more tax arbitrage, is very costly to the Treasury, and ought to be eliminated.

George Break and Joseph Pechman, of the Brookings Institution, argue, "The major function of personal deductions is to adjust for unusual circumstances that have a bearing on an individual's capacity to pay income taxes...The deduction for interest on consumer loans is clearly a subsidy to those who borrow for current consumption." 3/

Harvey Brazer, of Johns Hopkins, concurs in finding no justification for the interest deduction, observing: "Deductibility in this instance does not appear to serve any overriding social purpose. Interest payments cannot be said to represent extraordinary unbudgetable expenses and the deductibility of interest on consumption loans is not required in order to arrive at the net income of the taxpayer."4/

John Due, also of Brookings, makes arguments in a similar vein. Due notes that one might justify the personal interest deduction on grounds of ill fortune or catastrophe, or on grounds of administrative feasibility. He states, "Logically, interest on money borrowed for business purposes should be deductible and that for consumption use should not be." He feels that interest deductions do not meet the requirements of either justification, as a large portion of borrowing is discretionary. Due also suggests that the argument that it is administratively difficult to separate business and non-business interest is not necessarily compelling. Due notes that in the United States investment and consumption interest must already be separated because of the limitation of interest deductibility. He also notes that consumer interest deductions are not allowed in other countries; the implication is that these other countries have managed to administer such a rule. 5/

What is of interest here, Mr. Chairman, beyond the convincing nature of these arguments, is that they span the political spectrum. From Milton Friedman to Joseph Pechman, from the Brookings Institution to the American Enterprize Institute, there is general agreement on this issue: the consumer interest deduction doesn't make sense.

THE CONSUMER INTEREST DEDUCTION FAVORS HIGH INCOME INDIVIDUALS

The consumer interest deduction is discriminatory and regressive in its effects. It tends to favor high income individuals and provides little benefit to lower and middle income individuals, a particularly unfortunate circumstance, as these individuals may be more likely to be forced by economic necessity to borrow in times of hardship. The borrowing of higher income individuals is much more likely to be discretionary and to be used for luxuries such as travel, entertainment and less than essential purchases.

There are three main reasons for the tilt of the interest deduction towards higher income individuals:

(1) The interest deduction is an itemized deduction, and as such is only available to individuals who itemize rather than taking the zero bracket amount. Data for 1980 indicates that only [illegible] percent of returns itemized deductions (See Table). For returns which report adjusted gross income of less than $20,000, accounting for 68 percent of all returns, only 12 percent of returns were itemized. For returns with adjusted gross income of $20,000 to $50,000, 67 percent of returns were itemized. For returns with adjusted gross income in excess of $50,000, 94 percent of returns were itemized. In part as a result of this low rate of itemization among lower bracket taxpayers, the

average non-mortgagee interest deduction was only $46 for returns of $20,000 income and less. By contrast returns of taxpayers with $20,000 to $50,000 deducted $493 and returns with over $50,000 income averaged $3,076!

(2) Even for those returns that itemize, the average deduction rises as income rises. Itemized returns below $20,000 report an average of $371 in non-mortgage interest; returns in the $20,000 to $50,000 range report average deductions of $737 and returns with $50,000 and over income report $3,264.

(3) Finally, the dollar benefit to higher income individuals is much more pronounced than that for lower income individuals because high income individuals have higher marginal tax rates. Thus, individuals in the over $50,000 class may be subject to a 50 percent tax rate and save half of their $3,076 deduction (or $1,538). An individual in the $20,000 and below bracket may be subject to a 14 percent rate, which on his $46 average deduction will save a paltry $6. (See Table III)

LIMITS ON THE CONSUMER INTEREST DEDUCTION WILL NOT AFFECT RETAIL SALES

It has been suggested that the phase out of the deduction for consumer interest expense may have an impact on consumer spending. I believe there is no basis in fact for this contention. It is argued that, if the after tax cost of borrowing increases for the 17 percent of the taxpayers who take the consumer interest deduction, consumer borrowing will decline and retail sales will drop as a result. But let's look at the facts.

Interest rates in the 1970's and 1980's have moved with unprecedented volatility. The prime rate, for example, was 6.8 percent in 1976 and 20 percent in June of 1981. The T bill rate was below 5 percent in 1976 and peaked at over 16 percent in 1981. Rates on consumer loans have moved in a similar manner. Yet consumer installment credit as a percentage of the consumers liquid assets has remained almost constant throughout this period, as you can see from Table IV in the appendix. How can we account for this except to say that consumer credit demand seems fairly inelastic, it is apparently not very strongly affected by the price of credit. In spite of a doubling, or even tripling of interest rates, consumer borrowing has held relatively constant.

Therefore, the loss of the consumer interest deduction cannot be said to have a negative impact on consumer spending when we have already seen, in data prepared by the National Consumer Finance Association, that this demand is nearly constant. Further, I would point out that we have taken a very moderate approach to the deduction for consumer interest in this bill by phasing it out over four years. Some would say too moderate, in light of the arguments against its retention.

THE DEDUCTIBILITY OF INTEREST IS A HEAVY SUBSIDY TO BORROWING

The deductibility of interest constitutes a substantial subsidy to borrowing, and this subsidy is magnified in inflationary times. Consider for example, the differences between a non-itemizer, an itemizer in the 26 percent tax bracket, and an itemizer in the 50 percent tax bracket. Suppose the inflation rate is 8 percent and the cost of interest is 16 percent. The after tax cost of borrowing for the non-itemizer is 16 percent (the actual interest rate). The after tax cost for the 26 percent rate itemizer is 11.8 percent, and the after tax cost for the 50 percent borrower is only 8 percent. The real cost of borrowing is measured by subtracting the inflation rate from the after tax cost. This results in an 8 percent real cost for the non-itemizer, a 3.8 percent cost for the 26 percent bracket, and a zero cost for the 50 percent bracket! Thus, interest deductibility has, in this example, effectively made borrowing costless for the high bracket taxpayer in real terms.

BUDGETARY IMPACT OF S. 2214

S. 2214 would create a solid, well thought out method of encouraging the public to save and invest more in our economy and it would do this at no cost to the Treasury. On the contrary, as Table V indicates, it would produce $15.45 billion in revenues over a five year period according to the Joint Tax Committee. I recognize that there are indeed revenue losses in bothe 1982 and 1983, years in which we are very concerned about reducing the deficit. There are, however, several options available to the Committee for eliminating the losses in these years and I will be happy to provide them to the Committee at a later date if necessary.

CONCLUSION

Mr. Chairman, all aspects of the economy and all segments of our population would benefit from the legislation before your subcommittees today.

A substantial increase in the propensity of American taxpayers to save and invest is essential if the economy of the 1980's is to be one of strong, real growth. Full employment and low inflation can only be achieved if there is sufficient capital to finance the investments required to make new discoveries, technologies, and build new plants. Recent studies have shown a close correlation between rates of growth and the rates of savings and investment internationally. It is no coincidence that the United States, with the lowest rate of personal savings among major industrialized nations is also affected with stagnating economic growth.

Mr. Chairman, it is clear that in the past the United States has unintentionally created a tax system that is heavily weighted in favor of debt and consumption, and against savings and investment. This bill is intended as a complement to steps already made to reverse the weighted scales, and is designed to insure that the hoped-for increases in savings and investment our economy must have if it is to grow will in fact occur.

Thank you.

FOOTNOTES

1/ U.S. Congress. Senate. Committee on the Budget. Tax Expenditures. 97the Congress, 2d Session, March 17, 1982, p. 134.

2/ These debates are traced in Seidman's Legislative History of Federal Income Tax Laws, 1938-1861, by J.S. Seidman, Prentice-Hall, New York, 1938.

3/ George F. Break and Joseph Pechman, Federal Tax Reform: The Impossible Dream, The Brookings Institution, Washington, D.C., 1975, pp. 21-23.

4/ Harvey Brazer, "The Income Tax in the Federal Revenue System" In Broad Based Taxes: New Options and Sources, Ed. Richard A. Musgrave, Johns Hopkins Press, Baltimore, Md., 1973, p. 17.

5/ John F. Due, "Personal Deductions," in Comprehensive Income Taxation, Brookings Institution, Washington, D.C., 1977, pp. 38-39.

TABLE I

Distribution of Returns and of Interest and Dividend Income
Reported on Taxable Returns,
by Size of Interest and Dividend Income
(1981 Levels)

Amount of Interest and Dividend Income	Cumulative Percent of: All Returns	Cumulative Percent of: Returns With Interest and Dividend Income	Cumulative Percent of All Interest and Dividend Income
	(...........................	percent.	...................)
$100 or less	56.8	24.2	0.3
200 or less	62.8	34.7	0.8
300 or less	66.9	41.9	1.3
400 or less	69.6	46.7	1.8
500 or less	71.8	50.5	2.4
1,000 or less	78.1	61.5	4.8
1,500 or less	81.8	68.1	7.3
2,000 or less	84.2	72.3	9.5
3,000 or less	87.5	78.0	13.8
6,000 or less	92.6	87.1	25.6
10,000 or less	95.7	92.4	38.0
Total	100.0%	100.0%	100.0%

TABLE II

Returns Itemized and Average Non-Mortgage Interest Deduction, 1980

Adjusted Gross Income Class ($000)	Percentage of Returns that Itemize	Percentage with Interest Deductions	Average Non-Mortgage Interest Deduction: All Returns	All Iteized Returns	All Returns with Interet Deductions
0-5	2	1	7	296	807
5-10	7	6	44	610	788
10-15	18	16	82	460	520
15-20	32	30	74	230	248
20-25	51	49	169	333	348
25-30	65	62	247	381	396
30-40	79	75			
40-50	91	84	916	1120	1179
50-75	93	84			
75-100	95	84	2078	2225	2468
100-200	96	83	5198	5410	6232
200-500	98	84	12685	12953	15191
500-1000	99	82	31424	31424	37753
1000 and over	98	82	80479	81289	98082
Total	30	27	274	891	1003
Summary					
0-20	12	11	46	371	433
20-50	67	64	493	737	772
50 plus	94	84	3076	3264	3652

Source: Data on Number of Returns and Total Interest Deductions by Income Class from Statistics of Income Bulletin, Winter 1981-1982. Interest allocated between mortgage and non-mortgage interest based on 1978 data, Statistics of Income, 1978, Individual Income Tax Returns.

TABLE III

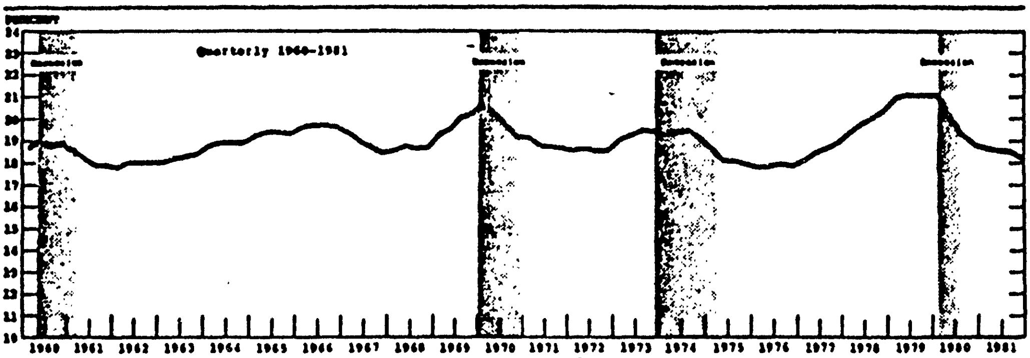
Number of Returns and Total Estimated
Non-Mortgage Interest Deductions, 1980

Adjusted Gross Income Class ($000)	Total Returns (millions)	Non-Mortgage Interest deductions ($millions)
0-5	19.95	133
5-10	18.37	804
10-15	14.28	1174
15-20	11.09	826
20-25	9.13	1542
25-30	6.78	1677
30-50	10.94	10026
50-100	2.53	5266
100-200	.434	2256
200-500	.097	1230
500-1000	.012	377
1000 and over	.004	331
Total	93.62	25642
Addendum		
0-20	63.69	2937
20-50	26.85	13245
50 and over	3.077	9460

Source: Data on Number of Returns and Total Interest Deductions by Income Class from Statistics of Income Bulletin, Winter 1981-82. Interest allocated between mortgage and non-mortgage interest based on 1978 data, Statistics of Income , 1978, Individual Income Tax Returns

TABLE IV

Ratio of Consumer Installment Credit Outstanding to Consumer Sector's Liquid Assets



Ratio of Repayments of Consumer Installment Credit to Disposable Personal Income

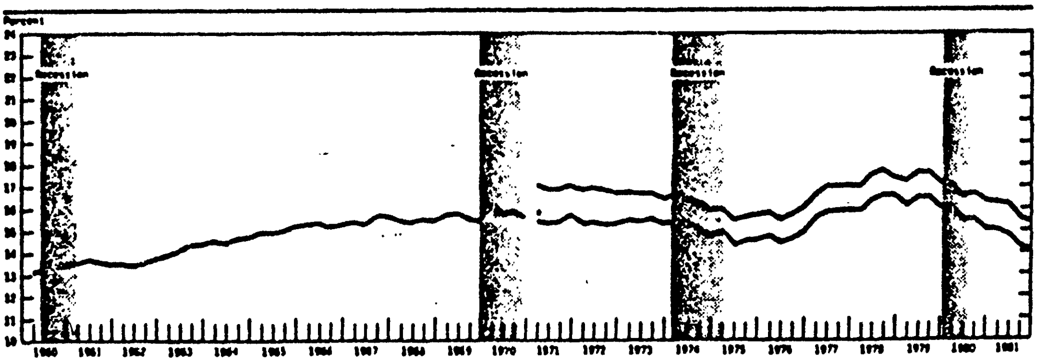


TABLE V

S. 2214 As Introduced

Year	FY 82	83	84	85	86	87
Revenue from elimination of deductibility of interest expense (Billions)	$.073	1.368	3.458	6.455	6.985	7.511
Loss from interest income exemption	.233	2.123	3.168	2.579	1.087	1.206
Net revenue impact	-.160	-.755	+.290	+3.876	+5.898	+6.305

Total FY82-87: +15.454 Billion Dollars

Senator PACKWOOD. Our first witness today is the Honorable John E. Chapoton, the Assistant Secretary for Tax Policy of the Treasury.

As I indicated earlier, Buck, while we hold the other witnesses to our 5-minute limit, we don't do that with Treasury because you've got to comment on all of the bills that we have before us today.

Good morning.

Secretary CHAPOTON. Good morning.

Senator PACKWOOD. Do you have an opening statement?

Secretary CHAPOTON. No, I haven't.

Senator PACKWOOD. Your entire statements will be in the record, Buck, and you don't have to read them verbatim; but take such time as you feel necessary to go over the bills that we have.

Mr. Secretary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF TREASURY

Secretary CHAPOTON. Thank you, Mr. Chairman.

We have got three bills this morning. I will cover S. 2214 that Senator Schmitt just covered first.

As the Senator indicated, this is a bill which goes to the question of the treatment of interest, both on the interest income and interest outflow side. As he also mentioned, there is a provision in the law now that was enacted in 1981 in the Economic Recovery Tax Act, which would allow an exclusion much like the capital gain exclusion of 15 percent of net interest income.

S. 2214 changes that in several important ways. One, it reduces the ceiling. Under current law the 15-percent net interest exclusion is allowed only up to a maximum amount of $6,000 on a joint return, $3,000 on a single return. This bill would reduce that ceiling to $4,000 on a joint return, $2,000 on a single return. And then, it would also change, going the other direction. It would increase the 15-percent figure in current law to 25 percent. And it phases in; in taxable years beginning 1982, the 25 percent will be 12.5 percent.

Thus, the maximum annual exclusion would be $500 on a single return and $1000 on a joint return as compared, under current law, to $450 on a single return and $900 on a joint return.

Also, the bill would expand the net exclusion or the partial exclusion to certain forms of dividends in addition to interest.

And then, as the Senator mentioned, the bill would phase out the itemized deduction for certain types of consumer interest but allowing a deduction of interest on loans to buy or repair a residence or to buy an auto, to carry on a trade or business or investment activity, and to pay for higher education expenses.

Mr. Chairman, we have given this bill a good deal of study. We are not now in a position to take a firm position on this bill. Therefore, what I am going to have to do this morning is just to discuss some of the considerations that should enter in to the committee's thinking and that do enter into our thinking as we review this area.

I would just point out that it does attempt to deal with what we consider one of the most difficult areas in the tax law—that is, the treatment of interest. It is difficult on both the income side and the outflow side.

Speaking first on the net interest exclusion, I want to express some concern about the lowering of the ceiling, just talking in terms of a joint return, from $6,000 to $4,000, because that has the effect of reducing the incentive of the exclusion. The lower the cap placed on any savings incentive, the smaller the likelihood that it will affect taxpayers at the margin. In terms of revenue lost, an incentive with the higher cap is much more efficient than one with a lower cap. And this results from the obvious fact that taxpayers who are above the cap are given absolutely no incentive to increase savings; so, wherever you set the cap, those who are above it have no further incentive and the bill does not work. Therefore, when you lower the incentive, you reduce the numbers of taxpayers who are given incentives.

This bill compensates for the reduction in the cap, however, by increasing the rate of the exclusion from 15 percent to 25 percent, and this formulation will result in a net reduction in taxable income from these types of investments for all taxpayers. So it is important to keep in mind that the overall result will be an additional exclusion for all taxpayers, those above and below the cap, but we should be concerned about the fact that when you lower the cap you reduce the incentive.

I would also point out that the trade off between lowering the cap and raising the percentage does result in a net loss in revenue.

On the whole, of course, the bill is not a net revenue loser; it is a net revenue raiser, because it limits the deduction on consumer interest. As we review this, it seems clear to us that the sponsors of this legislation intend to send a message to taxpayers that we wish to reward those who will increase their net savings and, at the same time, reduce the subsidy to those who borrow from the stock of savings to finance their own consumption.

The question whether dividends should be made eligible for the net exclusion is a difficult one. When the administration proposed a net interest exclusion with the support of Senator Schmitt's bill in ERTA, dividends were deliberately omitted for a number of reasons: One, owners of dividend-paying stock were given a significant benefit in last years Tax Act in the reduction of tax at the corporate level through the accelerated cost recovery allowance. More importantly, though, the interest rate is far more sensitive to the rate of inflation than is the dividend rate. The interest rate must increase with expected inflation, because the real value of the underlying asset decreases with inflation. And, thus, the nominal increase in income from debt capital is overstated; it is above the real income, and this nominal amount is taxed.

To the extent that a net interest exclusion is meant to compensate for the inflationary component of the stated amount of income from capital, it is more appropriate to apply the exclusion to interest income than to dividend income.

Finally, of course, as Senator Schmitt mentioned, owners of dividend-paying stock do pay a double tax. That is a matter of concern to us. It is a matter that has concerned economists for a long time. It is a serious problem in our tax law—the double tax on corporate profits. But the problem is, the tax at the corporate level and applying a partial exclusion to dividends is, we think, probably an inexact and indirect way to compensate for the double-taxation problem, since it is in no way related to the amount of corporate tax paid.

Now, let me mention just a couple of considerations on the elimination of the deduction for consumer interest, which we think is probably the most significant aspect of this bill.

A number of arguments have been made in favor of eliminating that deduction. Senator Schmitt mentioned some of them. First, in an inflationary economy the real interest rate is overstated, and taxpayers who are deducting interest are deducting an amount in excess of their real interest cost; but, of course, if you were trying to offset just this point, you wouldn't necessarily disallow the entire deduction, you would disallow a portion of the interest deduction.

Second, there is a real need in our current economy to shift a greater portion of our resources into investment, and in that regard this bill would help direct gross savings into borrowing to finance investment rather than in borrowing to finance consumption.

In addition, as Senator Schmitt mentioned, consumer interest deductions are taken only on tax returns of itemizers. They represent a little more than 30 percent. Nonitemizers are a little less than 70 percent—that figure keeps dropping with inflation—and those 70 percent of taxpayers, of course, receive no benefit from the present consumer interest deduction.

So there are sound reasons for eliminating the consumer interest deduction. Our principle concern with doing so, on the other side, though, is the problem that you might generally refer to as the fungibility of money. Some taxpayers could easily get around the rule by simply borrowing against their home or their automobile or their business, and even if we attempted to apply a strict tracing rule to get at interest expense, allowing interest expense only on qualifying investment, that would not prevent a person from borrowing against a business and then simply retaining a lower amount of earnings in the business. The deductible business borrowings could replace nondeductible consumer borrowing.

Similarly, it would be extremely difficult to limit deductions for a taxpayer who reduced their equity in housing to finance consumption.

I want to stress that these problems are not just administrative problems; they go to the very heart of the intent of a rule which would deny a deduction for consumer interest—that is, I think, the main concern with eliminating the deduction for consumer interest—but it is a very significant concern.

So the question is going to remain. We want to study further, and we would hope the subcommittee would study further, whether the problems created by a partial elimination of the consumer interest deduction would outweigh the beneficial economic and revenue effects of the proposal. We look forward to working with the committee and with Senator Schmitt on those problems.

Unless you want to cover the alternatives, Mr. Chairman, I will now turn to the other two bills.

Senator SCHMITT. Mr. Chairman, I would just say that we would be happy to accept a proposal by the administration to increase the ceiling.

Senator PACKWOOD. I didn't quite get the suggestion they were proposing it so much as throwing out the idea for consideration. But you are talking about offer and acceptance; I'm afraid, Mr. Secretary, your offer has been accepted, if that was an offer.

Senator SCHMITT. Well, Mr. Chairman, the basis for a limitation on the eligibility for the incentive is, of course, to reduce the revenue drain and to balance the two proposals against each other. Therefore, the most desirable situation is one in which that cap is as high as it possibly can be.

Secretary CHAPOTON. Yes. My only point is, as Senator Schmitt and I have discussed and I know he fully understands, the lowering of the cap, while helpful on the revenue side, does go counter to the policy we are all trying to achieve.

Senator SCHMITT. We agree. But, again, the important thing is to begin to remove that fundamental disincentive. The 25-percent exclusion is a major step in that direction. Certainly it is more appealing than the current 15 percent.

In addition, Mr. Chairman, I think we must look and see whether there really will be a tendency for consumers to borrow against their existing assets. Taking out a second mortgage on a house that is already mortgaged is probably not the thing that people will normally do in order to go down and buy on credit or to avoid buying on credit. I just doubt if that would happen; but, again, that is an area that we can continue to explore.

Secretary CHAPOTON. The concern is that we'll give taxpayers incentive to rearrange their affairs to avoid the denial of the deduction. It is a concern, and a real concern.

The second bill before the committee, Mr. Chairman, is S. 2281, which relates to charitable contributions of computers and other technological equipment. Under current law, as you know, corporations may deduct, within certain limitations, all property contributed to charities. In the case of inventory or other ordinary income type property, the deduction is limited to a taxpayer's basis, which is basically its cost in the property.

Also, the total amount any corporation is permitted to deduct as a charitable contribution in any taxable year is limited to 10 percent of the corporation's taxable income.

There are currently two exceptions to the general rule that the deduction of ordinary income property is limited to the donor's basis. One is for corporate gifts of inventory to be used for the care of the ill and needy or infants, and the second is corporate gifts of scientific equipment and apparatus to colleges and universities for research and experimentation. In both cases the taxpayer's deduction is equal to basis plus one-half of the unrealized appreciation, and the total amount cannot exceed 200 percent of the taxpayer's basis.

S. 2281 would allow corporations larger deductions than under current law for charitable contributions of computers or other sophisticated technological equipment or apparatus if the property is contributed to a primary, middle, or secondary school for use in educating students. Only contributions made within a 1-year period would qualify.

The amount of the allowable deduction would be, as under the exceptions I have described in existing law, the sum of the taxpayer's basis in the property plus one-half of the unrealized depreciation and could not exceed 200 percent of basis.

Yes, sir?

Senator BYRD. Let's take an easy figure. If the basis of book value—that is what you are speaking about, I assume.

Secretary CHAPOTON. Yes, sir.

Senator BYRD. Say $10,000. You can take $20,000?

Secretary CHAPOTON. Under current law you can take $10,000. Under this bill you would have to know the fair market value of the property before you could answer that. Let's say the basis is $10,000 and the fair market value is $30,000. Then your answer would be correct; you could take one-half of the difference, so you could take $20,000. But also there would be a cap. The deduction could not exceed 200 percent of basis.

Senator BYRD. And that's current law?

Secretary CHAPOTON. No, that is this bill; but it is also current law for two other limited areas. But the basic rule on ordinary income property or on inventory property is the deduction is limited to $10,000 in your example.

Senator BYRD. Thank you.

Secretary CHAPOTON. The amount of the bill would also increase the percentage limit of a corporation's charitable deductions from the current 10 percent, which is applied across the board—10 percent of current annual taxable income. It would increase that to 30 percent.

So, 2281 would double the deduction allowable for gifts of inventory property, that is, up to 200 percent of basis, and could triple the amount of the deductions in any taxable year because it raises the 10 percent to 30 percent.

We recognize that the end result of having computers in every school, which is the purpose of this bill as we understand it, is highly desirable. Nevertheless, if this bill were enacted, the Government would be funding a computer education program through the tax system. S. 2281 would allocate resources to a particular form of education at a time of general fiscal restraint without competing against other worthy programs for scarce resources.

We believe, Mr. Chairman, that there are sound policy reasons behind the general rule that deductions for gifts of ordinary income property should be limited to a taxpayer's basis in the property. This general rule produces the same tax benefit to the donor as if he had sold the property for its full value and simply gave the full cash proceeds to charity. This tax benefit under existing law, the general tax benefit, is substantial.

Absent this rule, most, if not all, of the economic consequences of making the gift could be borne by the Government. In fact, absent the rule, gifts of ordinary income property could be made at virtually no cost to the taxpayer. The tax benefit would almost equal the proceeds of the sale if the property were sold, net of taxes, and in such a case we think there is virtually no charity in charitable giving.

Thus, 2281 runs counter to the policy of requiring donors to bear a significant portion of the cost of charitable giving.

We realize, as I mentioned, that current law does provide these two exceptions to the general limitation on deductions of ordinary income property, but we do not think that those exceptions should be broadened, particularly on an ad hoc basis, giving one industry or one type of recipient an advantage over others.

Senator BYRD. Would you indicate again the exceptions under the present law?

Secretary CHAPOTON. The exceptions under the present law, Senator Byrd are, one, corporate gifts to the ill, the needy, or infants—that is inventory, and I think primarily it probably would be drugs, although I am not certain about that—and the second is gifts of scientific equipment and apparatus to colleges and universities for research and experimentation. That was added, I believe, in last year's act.

Senator BYRD. Thank you.

Secretary CHAPOTON. If Congress wishes to reconsider the general rule that the charitable contribution for ordinary income property is limited to the basis, we think it should do so for all similarly situated taxpayers. The more exceptions to this type of rule that are enacted, the more difficult it becomes to rationalize different treatment for different taxpayers. We see no reason why the gift of computers to a school, for example, should be given better treatment than gifts of books to educational institutions.

I would also mention that we object to the proposal in this bill that would increase the maximum allowable deduction from 10 percent of current taxable income to 30 percent. This would permit the benefited corporations to obtain three times the benefit from contributions of computers than could be obtained by a corporation donating cash or other type of property to any other worthy cause such as cancer research or any type of worthy cause that we might all agree would certainly be a desirable recipient of charity. Therefore, we do object to creating a special exception in this case.

The existing limitation places, we think, a reasonable limit on the ability of corporations and their shareholders to divert potential tax revenues away from the Federal Government and to the particular activities they favor.

Finally, let me mention that we are concerned about the competitive considerations motivating the intended beneficiaries of the bill. These do present tax policy concerns to us. The case law is replete with examples of taxpayers whose charitable contributions have been limited in whole or in part because of some indirect benefit flowing to the taxpayer from the gift. And, although we realize that it is difficult to apply such an indirect benefit test, it seems clear that there is potentially more than goodwill to be derived from the provisions of this bill by those companies which use it. We question whether that would involve the sort of detached and disinterested generosity that the charitable contribution deduction is intended to reward.

So, Mr. Chairman, we are opposing all elements of S. 2281.

Then, finally, Mr. Chairman, and very briefly, S. 1928 is a bill that provides that discounts or other forms of price reductions received by taxpayers in settlement of specific lawsuits involving con-

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tracts with Westinghouse Electric Corp. shall not be included in gross income but shall reduce the basis of the property or the cost of services to which they relate.

Let me just summarize this by saying this is a matter that is an outgrowth of lawsuits between a number of utilities—a great number of utilities—and the Westinghouse Corp. in the early 1970's, when basically Westinghouse agreed to sell uranium to these utilities; and then, because of substantial increases in the cost of uranium, Westinghouse could not perform. Lawsuits resulted.

At the court's urging, settlements were entered into where the utilities were given cash payments, future discounts on uranium, future discounts on other goods and services, and a portion of any amount received by Westinghouse in its suit against an alleged uranium cartel.

These were complicated lawsuits. The facts in the cases of different utilities vary; with respect to the types of settlement they received. One of the utilities went to the Internal Revenue Service for a ruling, and the ruling held that cash payments and the right to future discounts to the taxpayers upon entering into the settlement agreement was a taxable event, was realization, and that the taxpayer would be required to recognize income to the extent the cash payments and the value of the discounts exceeded the excess cost of the covered uranium—that is, the replacement uranium—at the time of the settlement.

S. 1928 is private relief legislation which simply settles that dispute between the taxpayer and the IRS in favor of the taxpayer. We object strongly to this type of a settlement of a controversy. If the utilities disagree with the Internal Revenue Service on the application of the tax principles to these particular facts, that is a matter that must be settled in the courts as are disputes with other taxpayers, and we think it is very inappropriate for this to be settled through private relief legislation. Therefore, we are opposing that, Mr. Chairman.

Senator PACKWOOD. Thank you, Mr. Secretary.

[The prepared statement follows:]

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STATEMENT OF THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: S. 2281, concerning the deduction for charitable contributions of computers and other scientific equipment and S. 1928, concerning the tax treatment of a portion of the settlement agreement of a contract dispute between Westinghouse and a number of utility companies.

I will now discuss the Treasury's specific views on both of these bills.

S. 2281
Charitable Contributions of Computers and Other Technological Equipment

Under current law, a corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations. In the case of contributions of inventory, the amount of the deduction is limited to the taxpayer's basis in such property, which is the amount it cost the taxpayer to manufacture or produce the property in question. The total amount any corporation is permitted to deduct as a charitable contribution in any one taxable year is limited to 10 percent of the corporation's taxable income for such year, computed without the charitable deduction and with certain other adjustments. If the amount contributed exceeds this percentage of taxable income limitation, the excess may be carried forward and deducted over the five succeeding years, subject to the percentage of taxable income limitation in those years.

There are currently two exceptions to the general rule that the deduction for gifts of ordinary income property such as inventory is limited to the donor's basis in the property contributed. The first exception concerns corporate gifts of inventory to be used for the care of the ill, the needy, or infants. The second exception involves corporate gifts of scientific equipment and apparatus to colleges and universities for research and experimentation. In both cases, the amount of the deduction is equal to the taxpayer's basis in the property plus one-half of the unrealized appreciation, not to exceed twice the taxpayer's basis in such property.

S. 2281 would allow corporations (other than Subchapter S corporations, personal holding companies or certain service companies) larger deductions than under current law for charitable contributions of computers or other "sophisticated technological equipment or apparatus" which is of an inventory nature if such equipment is contributed to primary, middle or secondary schools for use in educating students. Only contributions made within one year of the date of enactment of S. 2281 would qualify. If all the conditions of the bill are satisfied, the amount of the allowable deduction will be the sum of the taxpayer's basis in the property plus one-half the unrealized appreciation in such property. However, in no event would the deduction exceed twice the taxpayer's basis in the property contributed. The bill would also permit a corporation to deduct up to 30 percent of its taxable income for contributions of such property. We understand that an amendment to S. 2281 is under consideration which would increase the limitation on carryforwards to 30 percent as well.

S. 2281 thus could double the deduction otherwise allowable for gifts of inventory property and could triple the amount of such deductions allowable for any one year. Treasury is strongly opposed to S. 2281.

We recognize that the end result of having computers in every school may be highly desirable. Nevertheless, if this bill were enacted, the government would be funding a computer education program through the tax system. In other words, S. 2281 allocates resources to a particular form of education at a time of general fiscal restraint, without competing against other worthy programs for scarce resources.

In many cases, the value of the tax benefit conferred will approximately equal the taxpayer's cost of the equipment. For example, if it cost the taxpayer $1,000 to produce equipment which he can sell for $3,000, he will be entitled to a deduction of $2,000. This produces a tax benefit of approximately $1,000, and the government would in effect be purchasing the equipment for cost.

Moreover, the individual taxpayer would determine the recipients of the equipment. The bill, as drafted, does not provide the government any right to oversee this program or any remedy if it is not administered in accordance with governmental policy. Although we assume it is not the intent of the proponents of this bill, a computer manufacturer could hardly be faulted if it placed its computers in schools whose students come from families which would be most likely to have the financial resources to purchase similar equipment for home use. Yet a federal outlay program targeted at these same relatively well-off families would hardly meet with Congressional approval.

Additional potential for abuse lies in the difficulty of administering this program. The amount of the permissable deduction depends upon the fair market value of the donated equipment. This might be difficult to determine if the donated product is not selling well in the current economic climate. Moreover, it is not clear, particularly in areas of high technology, whether the costs included in the inventory to be contributed (which costs will determine the amount of the deduction) might not significantly exceed the marginal costs of producing the individual units contributed.

Further, we believe there are sound policy reasons behind the general rule that the deduction for gifts of ordinary income property should be limited to a taxpayer's basis in such property. This general rule produces the same tax benefit to the donor as if he sold the property for its full value and simply gave the cash proceeds to charity. This tax benefit is substantial. Absent this rule, most if not all of the economic consequences of making the gift could be born by the Government. In fact, absent the rule, gifts of ordinary income property could be made at virtually no cost to the taxpayer -- the tax benefit could almost equal the proceeds (net of taxes) which could be realized from the sale of the property. In such a case, there would be virtually no charity in charitable giving.

Although S. 2281 does not go so far as to cause taxpayers to be indifferent between giving inventory to schools rather than selling it, it greatly reduces the economic distinction between the two transactions, and thus runs counter to the policy of requiring donors to bear a significant portion of the cost of charitable giving. Under S. 2281, there is very little charity left in giving qualified property to schools.

We realize that current law provides exceptions to the general limitation on deductions for charitable gifts of ordinary income property in the case of contributions of inventory items such as food, drugs and medical equipment to certain charities, and in the case of gifts of certain scientific equipment to colleges and universities. We also realize that primary and secondary school children would benefit as much from the use of such equipment as would college students. However, it is difficult to argue that students would not benefit as much from gifts of books, athletic equipment, maps, recording equipment and other educationally beneficial equipment as they would from gifts of computers.

If Congress wishes to reconsider the positions taken in the Tax Reform Act of 1969, it should do so for all similarly situated taxpayers. The more exceptions that are made the more difficult it becomes to rationalize different treatment for different taxpayers. We see no reason why the gift of computers to schools should be given better treatment than the gift of books to educational institutions.

For the reasons previously discussed, we believe that the general principle of section 170(e) is valid and should not be eroded by additional special exceptions.

Treasury also objects to the proposal in S. 2281 to increase the maximum amount allowable as a deduction in any one year from 10 percent to 30 percent of the donor's taxable income. By increasing the maximum allowable deduction, S. 2281 would permit a favored corporation to obtain 3 times the benefit from its contributions of computers or other sophisticated technological equipment than could be obtained by a corporation donating cash or other types of property for such worthy causes as cancer research. We question whether the donation of computers is more desirable than other types of charitable gifts, and we strongly object to creating this special exception to the maximum limitation.

The existing limitation on the maximum allowable charitable contributions deduction for corporations is based on sound policy grounds including the need to protect Federal revenues and to place a reasonable limit on the ability of corporations and their shareholders to divert potential tax revenues away from the Federal Government and to the particular activities they favor. The Economic Recovery Tax Act increased the limitation from 5 percent to 10 percent of a corporation's income, and we believe that the present limitation is appropriate.

Further, S. 2281 would only apply to gifts made within a one year period. While the purpose of this time limitation may be to provide for a limited exception to the general rule in an effort to encourage taxpayers to make qualifying gifts to schools while limiting the revenue loss from this exception, it is doubtful that many in the computer industry will be able to take advantage of this provision. We understand that, in general, the computer industry does not carry large inventories because rapid advances in technology often make current models obsolete. Taxpayers who are backlogged on orders would be unable to take advantage of the provision. Thus, those companies that could take advantage of the provision would have a significant competitive advantage. We understand that proponents of this bill are considering an amendment which would qualify gifts made between February, 1983 and February, 1984 in order to provide other companies an opportunity to increase production to take advantage of the legislation. However, we question whether many other companies will be able to do so.

The competitive considerations motivating the intended beneficiaries of the bill also present significant tax policy concerns. The case law is replete with examples of taxpayers whose charitable contributions have been limited in whole or in part because of some indirect benefit flowing to the taxpayer from the gift. We realize that it is difficult to apply this indirect benefit test to corporations which may expect to benefit from the goodwill generated by their charitable gifts. However, there is potentially more than goodwill to be derived from this provision by those companies that can take advantage of it. The companies that supply equipment to schools can at least expect service contracts for that equipment and at best can anticipate future sales from schools and students' families. We question whether this is the sort of detached and disinterested generosity that the charitable contribution deduction is intended to reward.

In summary, Treasury opposes S. 2281 because it further erodes the general principle of the 1969 Act that deductions for gifts of inventory should be limited to the donor's basis in that inventory, and it does so in a narrow fashion that benefits only one particular industry. It goes further than current exceptions to the general principle in increasing the percentage limitation for qualifying corporations. S. 2281 is likely to benefit only a very few taxpayers who, far from exhibiting the generosity typically associated with charitable giving hope to reap substantial commercial rewards from their gifts as well as the tax benefits made available by this provision.

S. 1928

Tax Treatment of Westinghouse Uranium Contract Damage Payments

S. 1928 provides that no discounts or other forms of price reductions on any property or services received by taxpayers in settlement of certain contract disputes with Westinghouse Electric Corporation shall be included in gross income, but shall reduce the basis of the property or cost of services to which they relate. Treasury opposes S. 1928.

The facts leading up to S. 1928 as we understand them are as follows:

A number of utilities entered into supply contracts with Westinghouse in the early 1970's. In 1975, Westinghouse informed the utilities that it would not perform under the contract. Its position was based on commercial impracticability since the price of uranium had increased fourfold. The utilities sued Westinghouse for breach of contract, and the Court found Westinghouse liable under the contracts. At the Court's urging, the utilities and Westinghouse entered into a settlement agreement under which Westinghouse is to provide the utilities with benefits in the following forms: (1) cash payments; (2) future discounts on uranium; (3) future discounts on other goods and services; and (4) a portion of any amount received by Westinghouse from its suit against an alleged uranium cartel.

From the time of Westinghouse's breach of contract and the date of settlement the utilities were forced to purchase cover uranium (that is uranium to replace what Westinghouse was obligated to deliver under its contract) at considerably higher prices than they would have had to pay under their original contract with Westinghouse.

One of the affected utilities submitted a ruling request to the Internal Revenue Service on the tax treatment of the settlement. The Service found that Westinghouse's failure to honor its uranium supply and fabrication contracts forced the taxpayer to acquire cover uranium and fabrication facilities from other sources. As a result, the taxpayer was entitled to recover from Westinghouse the difference between the cost of the cover uranium and facilities and the contract price.

The ruling held that cash payments and the rights to future discounts accrued to the taxpayer upon entering into the settlement agreement. However, because this agreement represented a reimbursement for the additional amounts the taxpayer paid to obtain cover uranium, the value of the cash and discounts would not be included in the taxpayer's gross income to the extent it could be applied to reduce the taxpayer's undepreciated basis in the excess cost portion of the cover uranium. The taxpayer would be required to recognize income to the extent the cash payments and discounts exceeded the excess cost of the cover uranium at the time of settlement.

S. 1928 is private relief legislation that would resolve the dispute between the utilities and the Internal Revenue Service in the utilities' favor. Under the bill, no utility would be required to include the value of any future discount in gross income, nor would any utility be required to reduce its basis in the cover uranium. Rather, the discounts would be taken into account by excluding the discounts from the utilities' basis in the goods or services acquired under the settlement agreements.

Treasury strongly opposes S. 1928. The appropriate income tax treatment of the Westinghouse settlement agreements depends upon the application of general tax principles to the particular facts of each utility's case. The resolution of such controversies is the function of the courts, which are equipped to ascertain the relevant facts and apply the established legal principles to them. We strongly believe that these disputes should not be addressed by the Congress through private relief legislation.

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

Mr. Chairmen and Members of these Subcommittees:

I am pleased to present the views of the Treasury Department on S. 2214, which would provide a partial exclusion for net interest and dividend income and would eliminate certain consumer interest deductions.

Overview

Under current law, beginning in 1985 individuals will be allowed an exclusion of 15 percent of net interest received up to $3,000 of net interest for a single return or $6,000 for a joint return. The maximum exclusion thus will be $450 ($900 on a joint return) per year. Net interest is defined generally as eligible interest received by a taxpayer in excess of itemized interest deductions. However, mortgage interest and trade or business interest payments do not reduce the amount of interest receipts eligible for the exclusion. In addition, current law allows individuals to exclude 100 percent of the first $100 of dividends received ($200 on a joint return) per year.

S. 2214 would change the net interest exclusion in several ways, the principal of which are as follows: First, the maximum amount of net interest eligible for the exclusion would be reduced from $3,000 to $2,000 on a single return and from $6,000 to $4,000 on a joint return. Second, the rate of exclusion would be increased from 15 percent to 25 percent, except for taxable years beginning in 1982, in which the exclusion rate would be 12.5 percent. The maximum annual exclusion thus would be $500

($1,000 on a joint return) after 1982. Third, most dividends would be made eligible for the exclusion and the current $100/$200 dividend exclusion would be repealed.

In addition, by 1985 the bill would phase out the itemized deduction allowed for certain consumer interest. Interest paid on loans used to acquire or reconstruct a residence, to acquire an auto, to carry on trade, business or investment activity, or to pay for higher education expenses, would be deductible as under current law.

The sponsors of this bill should be commended for their forthright effort to tackle one of the most difficult questions in the area of taxation: the treatment of interest income and expense. The question is difficult from an economic and technical, as well as political, viewpoint.

At this point the Treasury has not formulated a final position with respect to S. 2214. As you well understand, our position on this as well as many other revenue issues will in a large sense depend upon the outcome of the current debate on the budget. Nonetheless, I believe that it would be useful to discuss some of Treasury's concerns with S. 2214 as it is currently drafted. Let me note at the outset that because of the particular phase-in approaches adopted in the bill, there are net revenue losses in the early years. These losses are not large in the context of the total bill, but, given our current budgetary concerns, they detract from the bill. Some simple changes in the timing of the proposed amendments could solve this problem.

The Net Interest Exclusion

We have some concerns regarding the changes in the net interest exclusion. The proposed reduction in the maximum amount of interest eligible for the exclusion would have the effect of reducing the savings incentives provided by current law. Unfortunately, the lower the cap placed upon any savings incentive, the smaller the likelihood that it will affect taxpayers at the margin. Indeed, in terms of savings incentive provided per dollar of revenue loss, an incentive with a higher cap is much more efficient than one with a lower cap. Lower caps inevitably result in a greater percentage of revenue loss going to taxpayers for whom there is no incentive whatsoever, that is, to taxpayers who have interest and dividends above the cap amount. Thus, for a married couple with interest income of $5,000, the net interest exclusion in existing law would provide an incentive (beginning in 1985) for the couple to divert earnings from consumption to savings; no such incentive would be provided by S. 2214.

There is an equally valid equity argument for not lowering the cap. An important purpose of the partial exclusion is to compensate for the inflationary component of interest (or dividend) income. Viewed in this light, taxpayers with larger amounts of interest income are no less entitled to the exclusion. An income tax is meant to tax real income, and it is no more valid to overstate the real interest income of the wealthy than the nonwealthy, although a lower cap has just such an effect.

S. 2214 compensates for the reduction in the cap by increasing the rate of exclusion. While this formulation results in a net reduction in tax for all taxpayers, the bill nonetheless reduces the savings incentive impact provided (per dollar of revenue loss) by the current net interest exclusion that will take effect in 1985. Moreover, these changes in the partial exclusion, treated separately from the rest of the bill, are achieved only at a loss in revenue to Treasury.

To the extent that the bill is meant to be taken as a package, however, the above criticisms may be somewhat unfair. On the whole, the bill is certainly a net revenue raiser. Moreover, because the bill places limits on the deduction of consumer interest, the increase in the rate of exclusion for interest receipts may be viewed as compensation to many of those taxpayers who might face reductions in the amount of interest deductions that they could take. We take this to mean that the sponsors intend to send a message to taxpayers, a message which states that we need to direct more of our available gross savings into borrowing for investment rather than borrowing for consumption. As such, we wish to reward those who will increase their net savings and, at the same time, to reduce the subsidy to those who borrow from the stock of savings to finance their own consumption. This provides a more delicious main course, if you will, for those who will be forced to reduce their current consumption of dessert.

We question whether dividends should be made eligible for the net exclusion. We recognize that the bill does eliminate the $100/$200 dividend exclusion of current law, and that making dividends eligible for the new partial exclusion would compensate taxpayers to some extent for that change. Nevertheless, when the Administration first proposed a net interest exclusion last year, it deliberately left out dividends. In the Economic Recovery Tax Act of 1981, owners of dividend-paying stock were given tax reductions far more substantial than were given to owners of interest-bearing securities. The former group will benefit from accelerated cost recovery, while both groups will benefit from the rate reductions which apply to all realized capital income. Perhaps more importantly, the interest rate is far more sensitive to the rate of inflation than is the dividend rate. In the case of a corporation which maintains the real value of its assets, there is no basic reason why its dividend rate, expressed as a percentage of the value of those assets, would increase with expected inflation (except perhaps as an offset to the increased risk that individuals might feel in an inflationary environment). On the other hand, the interest rate must increase with expected inflation because the real value of the underlying asset decreases with inflation. Therefore, to the extent that a net exclusion is meant to compensate for the inflationary component of the stated amount of income from capital, it is more appropriate to apply the exclusion to interest income than to dividend income.

Owners of dividend-paying stock, of course, face a double tax burden not faced by owners of interest-bearing assets. To some extent, then, applying an exclusion to dividends may be thought of as one way of integrating corporate and personal income taxes. However, the method is indirect and inexact because the amount of exclusion is in no way related to the amount of corporate tax paid.

Elimination of Deductions for Certain Consumer Interest

In our view, the most significant aspect of the bill is not in the alteration of the net interest exclusion, but rather in the elimination of itemized deductions for certain consumer interest. The following arguments have been made in favor of this type of change. In an inflationary economy, the overstatement of the real interest rate by the nominal interest rate not only results in an excess amount of interest receipts includable in income subject to tax, but also an excess amount of interest payments being deductible by taxpayers. If inflation is 10 percent and the interest rate is 15 percent, a borrower pays only 5 percent in real terms just as the lender only earns 5 percent. Even if the tax laws are going to subsidize borrowing, it may be appropriate to limit the subsidy for borrowing used to finance consumption. However, while this argument would call for a reduction in the proportion of such interest that could be deducted, it would not necessarily call for its elimination. The argument for its elimination comes from two sources.

First, there is a real need in our current economy to shift a greater portion of our resources into investment. In that regard, the bill would help direct gross savings into borrowing to finance investment rather than borrowing to finance consumption. Second, it is well recognized in tax theory that the implicit income or flow of services from consumer goods is not subject to tax if the goods are owned outright. On the other hand, the owner would be subject to tax on that income if the same goods were rented to consumers. Since the implicit income from owner-used consumer goods is not subject to tax, it may be inappropriate to allow deductions for the interest payments or other costs of owning the goods. (To illustrate: a landlord is allowed deductions for interest costs of owning real estate because he takes rental receipts into income; obviously, there is no parallel income inclusion with respect to consumer goods.)

In addition, consumer interest deductions are taken only on tax returns with itemized deductions. Itemizers represent only 34 percent of all returns and are generally in higher income brackets. Elimination of the tax subsidy for borrowing for consumption, therefore, would apply principally to a group of taxpayers who can most easily convert current consumption to current savings.

The Treasury Department believes that these economic arguments have merit. Our principal concern with the elimination of the deduction for certain consumer interest paid arises from the fungibility of money. As a general proposition, we think it is clear that the proposed change would be effective in directing gross savings into borrowing for investment rather than borrowing for consumption. However, some taxpayers could get around the rule simply by borrowing against their house, auto, or business. A rule should require that any borrowing against a house, auto or business be matched by a direct investment in such assets. However, even if a strict rule were imposed to trace deductible interest expenses to qualifying investments, such a rule could not prevent a person from borrowing against a business and then simply retaining a lower amount of taxable earnings in the business. The deductible business borrowing would replace non-deductible consumer borrowing. Similarly, it would be extremely difficult to limit deductions for taxpayers who reduce their equity in housing as they move from one house to another. This reduction in equity is financed by increased borrowing, which, although tied to the new house, really goes to finance other types of purchases or investments.

A related concern of ours is that the bill would complicate lending practices. For instance, financial institutions can offer accounts in which dollars borrowed for any purpose show up as charges against one account. If some interest were to be deductible, while some were not, these types of accounts might be required to separate completely loans for one purpose from loans for another. Although obviously complex, complete separation of loans is probably the only feasible way to identify not only the purpose of the loan, but also the extent to which each repayment goes to reduce the principle related to non-deductible loans versus deductible loans.

Such difficulties are of course present in other parts of tax law. Taxes are inherently distorting and taxpayers will always structure their financial dealings to obtain the best tax result. The question that remains is whether the problems created by partial elimination of the consumer interest deduction would outweigh the beneficial economic and revenue effects of the proposal. We look forward to working with these Subcommittees and their staffs on such proposals.

	Revenue Change ($billions)					
			Fiscal Year			
	82	83	84	85	86	87
Change in Net Interest Exclusion	*	-2.2	-3.1	-2.5	-0.7	-0.8
Change in Consumer Interest Deduction	*	1.1	2.7	4.2	5.8	6.4
Total................	*	-1.1	-0.5	1.7	5.1	5.5

*Less than $50 million.

Senator PACKWOOD. We will follow the normal procedure in this committee of asking questions on a first-come-first-served basis and will limit ourselves to 5 minutes on the first round. We will give committee members a first shot, and then noncommittee members who have come to the hearings. So we will go with Senator Danforth, then Senator Byrd, then Senator Schmitt.

Senator DANFORTH. Mr. Chairman, two of the bills are mine. I would guess that in 5-minute spurts it would be difficult for me to cover them in the scope that I would like to. Therefore, what I would prefer to do is to wait until everybody else finishes their questions and maybe aggregate my opinions on the——

Senator PACKWOOD. Did you say "aggrevate"? [Laughter.]

Senator Byrd?

Senator BYRD. Well, one of the bills I am associated with Senator Danforth in. Suppose I just make a statement in regard to S. 1928.

Senator Danforth's staff and my staff have been working on this for quite a while. At least my staff was under the impression that Treasury would not oppose this proposal. Now, that understanding didn't come from you, Mr. Chapoton.

You mentioned this is a very complex matter.

Secretary CHAPOTON. Yes, sir.

Senator BYRD. My instructions to my staff were, and probably Senator Danforth the same, that it should be drawn in way that the consumers would benefit. It does seem unreasonable, if I understand the Treasury's position correctly, to require the payment of an income tax now on future discounts; in other words, on something that the utilities do not get until subsequent dates. Is that correct?

Secretary CHAPOTON. Senator Byrd, that is correct. That is a question involved in some of the cases, maybe even in all of them. I'm sure it probably is involved to some extent in all of the cases.

I think it is a question of whether that is a realizing event and whether there is value that should now be taxed under the applicable tax principles. And I understand the one utility that asked the Service for a ruling talked to the Service in meetings over at least a couple of year period, and I think that's the exact question that is raised

But that is either the law or not the law. It seems to us that if the law as stated by the Internal Revenue Service is incorrect, then we should probably clarify the law; or if the committee thinks it is correct, and should be changed, we should amend the law applicable to all taxpayers. I don't think we can resolve—indeed, I am not knowledgeable on all of the facts of this case. It is simply impossible to determine all the constraints as the Service attempted to do. And the Service can well be wrong. I don't want to imply that they are not wrong; I simply don't know. But it is not possible for us to pass on the correctness of the Service's determination in a context that just overrules the Service. It would be possible for us to review a restatement of tax principles, which this doesn't do.

Senator BYRD. It is a difficult, complex, and unusual situation and deals with public utilities which are guaranteed under the law a certain profit. So, in effect, whatever is done if this legislation is enacted, it seems to me the benefit would go not to the utility per se but to the consumers. Wouldn't that be the case?

Secretary CHAPOTON. I don't want to say all of it; certainly some of it is going to fall to the benefit of the consumers. On the other hand, if they have to litigate and engage the cost of litigation, a major portion probably of that burden would fall on the consumers.

Senator BYRD. Senator Danforth undoubtedly will address this, and if I may, let me join in with him at a later time and return to this matter.

Let me ask you about this. I was accosted by five or six irate small businessmen the other day. They weren't even from Virginia, they were from Ohio—very nice people, you understand. [Laughter.]

They were greatly concerned about a proposed ruling of the Internal Revenue Service dealing with section 385. Well, I had never heard of 385. They seemed to think I should know every detail of it.

Before this hearing is over, if the Chairman will permit and if it is satisfactory to you, I would like to get a little information about that proposed rule.

Secretary CHAPOTON. I would be happy to discuss it.

Senator PACKWOOD. Do you know what 385 is?

Secretary CHAPOTON. I am fairly familiar with section 385. Yes, sir.

Senator PACKWOOD. Senator Schmitt?

Senator SCHMITT. Buck, do you have any personal feelings about the variability of consumer installment credit in relation to consumer liquid assets over time? And what seems to affect that variability?

Secretary CHAPOTON. The variability of purchases of the consumer, did you say?

Senator SCHMITT. Yes.

Secretary CHAPOTON. I think I have not studied that in depth, but from what I have seen I don't think I see a great relationship between deductibility and——

Senator SCHMITT. It has been relatively constant, hasn't it? For example, the ratio of installment credit to liquid assets?

Secretary CHAPOTON. Yes, from the information I have seen, it is relatively constant.

Senator SCHMITT. Why does there seem to be more credit as interest rates go up, but less credit once we enter a recessionary period?

Secretary CHAPOTON. Well, I'm not sure I know, Senator. When you hit a recessionary period, I think taxpaying citizens begin to retrench. They don't want to be subject to the problems of debt as much.

Senator SCHMITT. Mr. Chairman, as I look at the history of consumer installment credit relative to consumer liquid assets, there is some variability but not a lot. You are talking about plus or minus a percent or two over the last several decades, even in recessionary periods. And it would be my feeling that the phaseout of the interest deduction would not significantly affect this relationship one way or the other.

Secretary CHAPOTON. I think that's hard to say; but, as you pointed out and I mentioned in my testimony, the consumer interest deduction is available already to a minority of taxpayers, in any event, and the question of whether it is a constant factor in the purchase of consumer durables is subject to debate.

Senator SCHMITT. Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Danforth, are you ready?

Senator DANFORTH. Yes, sir.

Senator PACKWOOD. Mr. Secretary, are you ready?

Secretary CHAPOTON. Yes, sir.

Senator DANFORTH. Mr. Secretary, first, on the question of S. 2281, this is the bill that has been known as the Apple bill, isn't that right?

Secretary CHAPOTON. That is correct. Yes, sir.

Senator DANFORTH. And the thought in this was an idea that it was conceived of by the Apple Co. We will find out later today, but I think that it is not unique to them, that it has been joined in by other competitors of the Apple Co. But, their offer, as I understand it, is to give these little computers to every school in the country.

Secretary CHAPOTON. That is as I understand it. Yes, sir. But let me say I don't know the terms of their offer. The bill wouldn't require it to every school in the country. It would simply allow a deduction under those terms for any gift to a school.

Senator DANFORTH. Yes. But I mean the proposal, as I understand it, is that they want to give these little computers to every school in the country provided that there are a couple of changes in the tax law. One, they want the 10-percent limitation on charitable contributions to be lifted. And, two, they want to be able to deduct not only the basis of the equipment but the basis plus 50 percent of the difference between the basis and the market value but not in excess of twice the basis. Is that correct?

Secretary CHAPOTON. Correct.

Senator DANFORTH. Now, in the case of a gift of a computer by a computer manufacturing company to a university, assuming that it's used for research, that computer would be able to deduct not only the cost but the cost plus 50 percent of the difference.

Secretary CHAPOTON. That is correct. That was enacted last year as a part of the change or the additional benefit designed for research and experimentation, along with, as I remember, the R. & D. credit.

Senator DANFORTH. So that this particular proposal is one that isn't just dreamed up out of the blue, but there is a precedent in the tax law for this kind of change in the law.

Secretary CHAPOTON. That is correct.

Senator DANFORTH. What if a school, say the Walt Whitman High School, were to set up a fund for the purchase of these little computers, and it were to solicit a contribution to the fund. And say the Apple Co. or one of its competitors were to contribute $10,000 to that fund; assuming that that did not go over the 10-percent limitation on contributions, what would happen? Would that be deductible as a charitable contribution?

Secretary CHAPOTON. That would be deductible. That would be, in effect, contributing dollars which would otherwise be subject to tax.

Senator DANFORTH. If it turned out that the Walt Whitman High School then turned around and bought an Apple computer for the money, there would be no prohibition on that, would there?

Secretary CHAPOTON. No, not at all.

Senator DANFORTH. What would be the tax consequences of that? Let's say the computer cost Apple $1,000 to make, and that they sell it at $3,000—market value—and that they contribute $3,000 in cash to Walt Whitman. Under those circumstances, under present law they would deduct the $3,000 as a charitable contribution. Right?

Secretary CHAPOTON. Right.

Senator DANFORTH. And then they would realize as income $2,000?

Secretary CHAPOTON. Correct.

Senator DANFORTH. So, the charitable contribution deduction would exceed their profit?

Secretary CHAPOTON. That's right. They would be in exactly the position if they did that as they would be if they gave the property under existing law. Existing law is a wash whether they sell the computer for the $3,000 and give the full proceeds or they simply give the computer without the sale. In both cases they are then giving up the $1,000 cost or the $3,000 value, whichever way you want to look at it. And the transaction has some cost to the computer company. The tax benefit reduces that cost to some extent, but it does not make it in effect whole. If, however, you increased the amount of the deduction to 200 percent, in those facts, they would have a $2,000 deduction. Then the tax savings would equal the cost, and so there basically would be no cost to the computer company.

Senator DANFORTH. But if they did it by contributing cash?

Secretary CHAPOTON. There would be a very definite cost.

Senator DANFORTH. What?

Secretary CHAPOTON. There would be a definite cost. If they contribute the cash they receive from the sale of the computer, the net result is——

Senator DANFORTH. No, no. That's not what I am saying. Let's suppose that they do the following: They say to Walt Whitman, 'If you go to the store and buy one of these things, it will cost you $3,000; therefore, we give you $3,000 cash."

Secretary CHAPOTON. Well, obviously it would cost them $3,000. And if they were purchasing their computer, they would get the $3,000 back, and they would have a charitable contribution deduction offsetting the income. They would be out one computer.

Senator DANFORTH. They would be out one computer?

Secretary CHAPOTON. Right, the value of a computer.

Senator DANFORTH. They would be deducting $4,000, wouldn't they? They would be having a charitable contribution of $3,000; a business expense of $1,000, and the sales price of $3,000.

Secretary CHAPOTON. Right. A net taxable income of $2,000, and they would have a charitable contribution deduction.

Senator DANFORTH. A charitable contribution of $3,000. So the charitable contribution deduction would exceed the taxable income.

Secretary CHAPOTON. Well, no. It wouldn't exceed the total taxable income. They put $1,000 into the computer, plus another $2,000 that they realize in the related transaction. So the result would be the $2,000 taxable income——

Senator DANFORTH. Wouldn't they be better off under that situation than they would under this bill?

Secretary CHAPOTON. No. They would be worse off.

Senator DANFORTH. How?

Secretary CHAPOTON. If the starting point is they have a computer worth $3,000, which is on their books at a cost of $1,000; if they sell that, they have net cash, after paying the resulting $1,000 tax $1,000 ahead. If they give the full $3,000 proceeds, they are $1,500 ahead and they no longer have the computer. They have, in effect, given a computer. The tax system provides, in effect, no benefit beyond the reduction of the $2,000 of additonal taxable income.

Under this bill they can give the computer and take a $2,000 taxable deduction, which gives them roughly a $1,000 benefit which equals their cost. It is exactly tantamount to the Federal Government purchasing from Apple that computer for a $1,000, at cost.

Senator DANFORTH. Not quite, but close.

Secretary CHAPOTON. Close. The difference would be between the 46 and 50. Correct. But that's far different from creating taxable income and then contributing the proceeds.

Senator DANFORTH. I don't know. It seems to me that if you realized $2,000 of taxable income, and you make a $3,000 charitable contribution, it is about the same, isn't it?

Secretary CHAPOTON. Well, no, it isn't. I thought in the example, what you are describing is allowed under existing law. And, as I stated earlier, it is basically a wash, whether you contribute the computer and take the deduction of $1,000 or you contribute the cash after tax to offset the tax created by the transaction.

Senator DANFORTH. Let me ask you this. On the question of a taxpayer, you put a lot of weight on the question of, "Well, this would allow the taxpayer to collect computers over textbooks, and maybe the schools should have textbooks rather than computers." And somehow that weighed into your analysis of the situation. I'm not sure how.

Secretary CHAPOTON. Senator, the point there is: When we do something like this I think there is some give, but basically the Government is paying for the cost of the computer. And that program is being administered by private industry and is giving the computers to the schools. This committee would be deciding that that is a valuable—indeed, it is unquestionably a valuable transaction, a clearly desirable transaction; but it is an allocation of resources in favor of other desirable allocation of resources, other desirable charities, and it simply is not going through the process of analyzing this allocation in light of whatever other claims on those resources should be considered.

Senator DANFORTH. So, really, the issue here is whether it is of such value to the education of kids to have these little computers available for their education that we are willing to take up the computer industry on a deal which it is offering.

Secretary CHAPOTON. Whether we are willing to buy computers at cost from the computer industry and put them in the schools.

Senator DANFORTH. Yes. That is really taking them up on a deal, isn't it? I think your analysis is right. That is basically what it is. Not quite.

Secretary CHAPOTON. Not quite. Right.

Senator DANFORTH. Because they have a fraction.

Secretary CHAPOTON. That's true. And they'll have distribution costs.

Senator DANFORTH. But it is saying that instead of having the schools pay much larger amounts in going out and buying these things, we will allow the contribution to be made and finance it by the Tax Code. And I think that that is a fair analysis.

But, really, isn't the question for the committee whether that is such a valuable thing to do that we won't let the deal pass us by, when we do have a precedent which now exists with respect to contributions of research equipment by perhaps the same company to colleges and universities?

Secretary CHAPOTON. Well, Senator, I might suggest that if you made the offer to other manufacturers of products that various desirable charities might be interested in and said that you would buy their products at cost, if they could distribute those products to charities of choice, you might have a lot of takers.

Senator DANFORTH. You might have a lot of takers. We are not anticipating doing that; we are saying that here is one particular offer that has been made, and it's a great social benefit to the country to have kids that are able to work and think and be very facile with this particular type of equipment. There was a cover article on Time magazine within the last 2 or 3 weeks—a cover article—on the question of these computer kids and the importance of young people having this kind of education. And it would be possible for us to make a determination that this would be a very desirable thing to do.

Secretary CHAPOTON. That would be the determination: more desirable than other uses of Government resources. That is the determination that would have to be made. That is correct.

Senator SCHMITT. Would the Senator yield?

Senator DANFORTH. Surely.

Senator SCHMITT. This wouldn't cover Pac-Man, would it? [Laughter.]

Senator DANFORTH. I don't think it would cover Pac-Man.

Senator SCHMITT. I think we would have to be careful and make sure it doesn't. We would have a lot of parents unhappy with us.

Senator DANFORTH. Let me ask you about the Westinghouse situation. The situation, as I understand it, is as follows: Westinghouse enters into a contract with a utility to sell that utility uranium. Westinghouse breaches the contract. The utility sues Westinghouse for the difference between the contract price and what it had to cover for. Is that right?

Secretary CHAPOTON. That is correct.

Senator DANFORTH. There is a settlement of that case, and under the terms of the settlement Westinghouse on future sales to the utility has to offer a discount.

Secretary CHAPOTON. That is correct.

Senator DANFORTH. Those future sales occur over a period of time. They could occur over the next 5 years or 10 years or something like that.

Secretary CHAPOTON. That is my understanding. Yes.

Senator DANFORTH. So now, under the terms of the agreement the price that has to be paid in the future by the utility to Westinghouse for whatever it is going to receive is less than it might otherwise have to be.

Secretary CHAPOTON. That is correct.

Senator DANFORTH. And it is the Treasury's position that that is a realization of income at the date of the settlement?

Secretary CHAPOTON. Let me hasten to add, Senator, that that is the IRS's determination on the particular facts of the case presented to it. I don't know but I will even assume that those facts were basic to the other cases, there are a number of utilities involved, and that the IRS would have reached the same determination on the others. We have not been asked to decide whether those tax principles are correct or not.

Senator DANFORTH. So your view is that you don't have a position one way or another on the merits of the proposal?

Secretary CHAPOTON. Absolutely not. And I think it's almost impossible to until you see the facts of a particular case, whether there is an ongoing relationship with Westinghouse, whether the utility is continuing to buy uranium elsewhere, the value added to the utility. But the basic question I think you are driving at is whether that should be a realization event and whether that value should be picked up as taxable income. I think that is a question that can be seriously raised. But we have no way to judge that without a very detailed examination of the facts. And, indeed, our agency that is charged with making such examinations has made it and has determined that it is taxable. Now, taxpayers disagree with the Internal Revenue Service constantly.

Senator DANFORTH. I am not talking about the adjudication of a particular fact situation, but on the question of tax policy do you have any problems with the bill?

Secretary CHAPOTON. There is no question of tax policy as far as I can see it in this bill, because we have not been asked. I talked to the representatives of the utilities and said that if they would want to present a question of tax policy, that is, to change existing law in a certain respect, we could then review it. We have not been asked to do that.

Senator DANFORTH. But you have not taken a position one way or another on the policy that is implicit in this bill?

Secretary CHAPOTON. I have not.

Senator DANFORTH. And, therefore, your objection to the bill is exclusively from the standpoint that it is special legislation, that it relates to the determination of a particular fact situation growing out of a particular lawsuit?

Secretary CHAPOTON. That is correct. And, in addition I certainly am not willing to assume the IRS is wrong, either. I mean the IRS takes positions that are overruled by the courts many times, so it wins more than it loses; but it may well be correct here.

Senator DANFORTH. Do you have any initial reaction to the tax policy question?

Secretary CHAPOTON. Well, the tax policy question is not easily formulated. I assume it is a realization question; that is, when the uranium contract was canceled and a contract for future value was entered into, whether that is a realizing event.

I don't have any question at all with the tax policy or the tax principle that if I have one contract and I exchange it for another that that is a realization event.

Now, in a particular fact situation, that may well not be the principle involved. I simply don't know, Senator.

Senator DANFORTH. It would seem to me a little strange that a present reduction of future contractural obligations would be a realization of income today.

Secretary CHAPOTON. I'm sorry. A present——

Senator DANFORTH. That a present reduction of a future obligation under a contract.

Secretary CHAPOTON. Well, there is value involved, clearly. The present value of that future right is currently available to the company. I would be very hesitant to state that there is no taxable income from such a transaction, but I simply cannot state. And I am advised that rights were transferable, which certainly implies there is current value.

Senator DANFORTH. Yes.

Now, how many companies are involved in this? Do you know?

Secretary CHAPOTON. Over 20. I thought I had seen a figure somewhere of over 30; but a number of companies.

Senator DANFORTH. Somewhere over 20 or over 30 utilities are involved in it?

Secretary CHAPOTON. Yes, sir.

Senator DANFORTH. And do you have any idea how many people those serve?

Secretary CHAPOTON. No; I don't. I'm sure that they would give us that. But a great number of people.

Senator DANFORTH. Many, many, many people.

Secretary CHAPOTON. Right.

Senator DANFORTH. And it is reasonable to think that, however this matter is determined, it would have an effect on utility rates, isn't it?

Secretary CHAPOTON. It will have some effect on utility rates. I want to be very cautious, because I don't know the magnitude of it in relation to the overall size or the tax liability of the individual utilities.

Senator DANFORTH. It would have some effect?

Secretary CHAPOTON. It surely ought to have some effect.

Senator DANFORTH. So this is not simply a matter that relates to 1 or 2 companies; it relates to 20 or 30 companies, and it relates to the utility bills paid by many, many individuals.

Secretary CHAPOTON. I think that would be a correct statement.

Senator DANFORTH. Right.

Senator BYRD. There are hundreds of thousands of people involved.

Secretary CHAPOTON. I'm sure that's true, Senator.

Senator BYRD. Maybe even millions, I don't know; but certainly hundreds of thousands are bound to be with 20 to 30 utilities.

Secretary CHAPOTON. I'm sure that's true; but my point is that utilities have significant tax problems all the time. They are major investors in capital equipment; they have major tax benefits; they have this very difficult question of normalization of their tax benefits. It is a constant matter of controversy. They resolve these controversies, and every time the question is going to have the same effect that we are now discussing partially on the investors in the utility and partially on the customers of the utility. It is simply another controversy involving a utility which I think can be resolved. Particularly if, as the representatives of the utilities maintain, the Internal Revenue Service is clearly wrong, then that ought to be fairly easily resolved in the court.

Senator BYRD. It seems to me that the Treasury goes a little far when its paper submitted to the committee calls it a private relief legislation, when it appeals to hundreds of thousands if not millions of persons. It seems to me it goes a little bit far to put it in the category of a private relief bill. And I think the legislation provides for a passthrough, or requires a passthrough, requires the customer to receive the benefit.

Secretary CHAPOTON. I don't think the legislation does, but I think we can assume that the ratemaking bodies would require a significant passthrough.

I classify it as private relief. Let's assume for the moment that the Internal Revenue Service is correct. Then, by this legislation, we would overturn a correct rule that is applicable to all other taxpayers and will continue to be applicable to all other utilities and all other taxpayers to the benefit of the ratemakers and the stockholders of those utilities. And in that sense it is very definitely private relief, since it is not available to other utilities or other taxpayers who have similar questions.

Senator BYRD. Well, could this legislation be changed to a degree that it would satisfy the Treasury?

Secretary CHAPOTON. Senator, I don't know this. I think that the only way we could even examine it from what I consider a tax policy standpoint is to have a principle of the law changed. And if the proponents of this bill would like to submit legislation which changes what they think is an erroneous IRS interpretation of the law, then we could certainly review that.

Senator BYRD. May I ask you now a question in regard to 385?

Secretary CHAPOTON. Yes, sir.

Senator BYRD. Now, bear in mind that you are dealing with one who does not know the details of this at all.

As explained to me, take a small company which needs funds for modernization, or whatever. And for one reason or another it either can't get a bank loan or doesn't want to get a bank loan. Today I find that more and more small companies have great difficulty in obtaining a bank loan. Now, does a person run into tax problems by one of the stockholders saying, "Look, I'll loan you the money. I'll loan you the money, and I'll be paid the going interest rate. And I'll loan it to you for a year or 2 years, or 6 months, or whatever. And I'll be paid the going interest rate." Now, is that not permitted under the present law?

Secretary CHAPOTON. In very general terms, if one stockholder who does not own all of the stock or more than 50 percent of the stock makes that agreement, I think there would be no problem under existing law or under these regulations. But if all the stockholders in proportion to their stock holdings loaned the company money and the result was that the debt/equity ratio of the company were high, basically, depending upon the facts, either above 3 to

1 or 10 to 1, then they could have a problem. And the problem would be that the contribution would be treated as equity and not debt.

Senator BYRD. Well, I can see, if they were done in proportion. But if they were not done in proportion, would that problem be unlikely to occur?

Secretary CHAPOTON. That problem would be unlikely to occur.

Senator BYRD. Now, explain to me, when it says "debt to equity ratio, the corporation does not exceed 3 to 1." Let me give you an example. Let's assume that paid-in capital of a particular company, to take an easy figure, is $100,000; and then assume that over a period of time the stock dividends equal another $100,000. Then, under the safe harbor proposal, a stockholder could loan three times the $200,000 without a problem?

Secretary CHAPOTON. The rule in the present proposed regulations, I believe, Senator, is three times the tax basis of the assets in the company.

Senator BYRD. Tax basis?

Secretary CHAPOTON. Tax basis; yes, sir. So whatever that basis is, three times that would be allowed with no problem. Now, a concern by parties in that is that tax basis may be below current fair market value, and the argument is made that you ought to use book basis or ought to allow fair market value to enter into it. And, as we all know, I think fair market value would be purely correct. It is very difficult, of course, for parties to agree on what fair market value is.

Senator BYRD. A stockholder could loan three times fair market value?

Secretary CHAPOTON. No. Under the present regulations, three times basis—three times tax basis of the equity in the company. In your description, three times $200,000 if the $200,000 did not represent any unrealized appreciation in assets.

Senator BYRD. Now, in the regulations there are 16 pages. And then I've got a chart here that the chairman gave me. It will take quite a while to figure out that chart.

It says, in regard to safe harbor, "Principal and interest." In general, the regulations under Section 385 provide a safe harbor "for a straight debt instrument issued by a corporation for its face amount whenever all of the following conditions are satisfied." Then it speaks of principal and interest. "The instrument has a fixed maturity date, provides for annual payments of interest at (1) the rate in effect under section 6622"—I don't know what that is.

Secretary CHAPOTON. That's the 20-percent rate.

Senator BYRD. The 20-percent rate?

Secretary CHAPOTON. Yes, sir.

Senator BYRD. All right.

"(2) the prime rate in effect at any local commercial bank or the rate two points above such a rate." Either one of those would be satisfactory, I take it.

Secretary CHAPOTON. Yes, sir.

Senator BYRD. "(3) a rate determined from time to time by the Treasury, taking into consideration the average yield on outstanding marketable obligations." Now, do you have to go to the Treasury to find out what the——

Secretary CHAPOTON. The idea there, I believe, Senator, was, where the other rates seem inappropriate as the 20 percent does right now, that the Treasury could publish a more current rate for use in the 385.

Senator BYRD. Well, would a company be safe in taking either the prime rate, which is now 16½ percent, or 2 percentage points above what the local bank might charge?

Secretary CHAPOTON. Yes, sir.

Senator BYRD. And from my understanding, what the Treasury wants to be sure of is that the loan is not made at too low an interest rate—not too high an interest rate, but too low an interest rate.

Secretary CHAPOTON. That is correct. Because if it is too low an interest rate, that is a determining factor to say that it is not disguised equity. If it is real debt, there will tend to be something like a market rate of interest paid on it.

Senator BYRD. Thank you very much.

Secretary CHAPOTON. Senator Byrd, I might add those regulations have caused a lot of difficulty. They are complex. We are reviewing them very closely now, particularly to see if they can be simplified. The point of them is to provide broad safe harbors so that the great preponderance of taxpayers can look at them and know that they are OK; although, I have to concede the regulations as presently drafted are very complex.

Senator BYRD. Judging by this diagram, it is more than complex—16 pages in here. But these businessmen, small businessmen, are deeply concerned about it. As I say, the are from the State of Ohio, and they say that they have very great difficulty in borrowing money right now, and they are just stymied.

Secretary CHAPOTON. I met with those same businessmen, Senator. [Laughter.]

Senator PACKWOOD. Mr. Secretary, by being opposed to Senator Danforth's Apple bill, you place yourself squarely in opposition of little children with computers. [Laughter.]

I hope you will deal more kindly with a bill that Senator Danforth's subcommittee will soon be hearing as a favor to me. Nike is headquartered in Oregon, and they want to import, tariff-free, 200,000 pairs of shoes a year that they manufacture overseas and give them to the Special Olympics for Handicapped Children Committee. I would hope the Administration would not be opposed to that particular group, also.

Senator Dole, a question?

Senator DOLE. No, I would just add a statement. I have some reservations about the computer bill myself. I think the Treasury ends up making the gift, not the manufacturer. Is that correct?

Secretary CHAPOTON. It amounts to a purchase at cost by the Treasury. Yes, sir.

Senator DOLE. That doesn't make much sense to me.

Secretary CHAPOTON. Well, it results in benefits to the schools, obviously, at that cost.

Senator DOLE. And benefits to the people who make the product, too, I assume.

Secretary CHAPOTON. Well, I think they are motivated by a very desirable end. I think there will be some indirect benefits to the contributors. Yes, sir.

Senator DOLE. You didn't bring up a package of a $95 billion worth of revenue raising measures, did you?

Secretary CHAPOTON. No, sir. We left that back at the Treasury. [Laughter.]

Senator DOLE. Good. [Laughter.]

I do have a statement I want to put in the record.

[The prepared statement of Senator Bob Dole follows:]

STATEMENT OF SENATOR DOLE
SUBCOMMITTEE HEARINGS -- MAY 7, 1982

THIS MORNING WE HAVE THE OPPORTUNITY TO HEAR THE OPINIONS OF THE ADMINISTRATION AND THE PUBLIC ON ONE TAX BILL OF BROAD GENERAL INTEREST AND TWO BILLS OF PARTICULAR CONCERN TO SOME SPECIAL CATEGORIES OF TAXPAYERS.

THE FIRST BILL, S. 2214 HAS TWO PARTS. THE FIRST PART RAISES REVENUES. IT DOES SO BY PHASING OUT THE INTEREST PAID DEDUCTION FOR CONSUMER CREDIT AVAILABLE TO THOSE WHO ITEMIZE DEDUCTIONS. AS MANY OF YOU KNOW, AN IMMEDIATE END TO THIS DEDUCTION HAS BEEN HIGH ON LISTS OF REVENUE RAISERS CONSIDERED IN THE RECENT BUDGET DEFICIT REDUCTION DISCUSSIONS. IT IS A GOOD IDEA.

FOR SEVERAL YEARS, THIS COMMITTEE HAS BEEN CONCERNED WITH THE TAX SYSTEM'S BIAS AGAINST SAVING. LAST YEAR WE MADE SIGNIFICANT STRIDES TOWARDS ELIMINATING THAT BIAS BY LIBERALIZING IRA'S AND ENACTING THE 15% NET INTEREST EXCLUSION. BUT PART OF THE BIAS AGAINST SAVING IS THE BIAS IN FAVOR OF NEGATIVE SAVING--THE BIAS IN FAVOR OF INCURRING DEBT. THE INTEREST PAID DEDUCTION, OF COURSE, IS THE CULPRIT CREATING THIS BIAS. IT SEEMS FOOLISH TO ME TO ATTEMPT TO REDRESS THE TAX SYSTEM'S BIAS AGAINST SAVING WITHOUT LOOKING AT HALF THE PROBLEM. BY ELIMINATING THE CONSUMER INTEREST PAID DEDUCTION, WE WOULD MOVE A LONG WAY TOWARDS GETTING THE TAX SYSTEM OUT OF THE BUSINESS OF TELLING THE TAXPAYER TO CONSUME NOW RATHER THAN SAVE. I DO NOT MEAN TO SUGGEST THAT BORROWING TO BUY A TELEVISION SET OR A FANCY RESTAURANT MEAL IS

WRONG--I JUST WANT TO KEEP THE TAX SYSTEM OUT OF THE CONSUMER'S DECISION.

ELIMINATING THE CONSUMER INTEREST DEDUCTION ALSO ELIMINATES AN INEQUITY BUILT-IN TO THAT DEDUCTION. THE CONSUMER INTEREST DEDUCTION, FIRST OF ALL, IS AVAILABLE ONLY TO ITEMIZERS, GENERALLY ONLY THOSE TAXPAYERS WITH MODERATE TO HIGH INCOMES. LOW INCOME TAXPAYERS GET NO BENEFIT. SECOND, THE BENEFIT OF THE DEDUCTION GOES UP AS THE TAX BRACKET (AND INCOME) GOES UP. A WEALTHY 50% BRACKET TAXPAYER HAS UNCLE SAM PAY HALF HIS BORROWING COST WHEN HE BORROWS TO BUY A DIAMOND NECKLACE. WHEN THE MIDDLE CLASS 25% BRACKET TAXPAYER BORROWS TO BUY A NEW REFRIGERATOR, HOWEVER, THE TAX SYSTEM ONLY PICKS UP ONE QUARTER OF THE INTEREST CHARGE.

NOT COINCIDENTALLY, ELIMINATING THIS BIAS RAISES CONSIDERABLE REVENUE. IF WE WERE TO REPEAL THE DEDUCTION ALL AT ONCE, WITH LIBERAL EXCEPTIONS FOR MORTGAGE LOANS, AUTO LOANS, BUSINESS AND INVESTMENT LOANS, WE COULD INCREASE REVENUES NEARLY $6 BILLION A YEAR BY 1985.

THE SECOND PART OF S. 2214 WOULD LIBERALIZE THE 15% NET INTEREST EXCLUSION INCLUDED IN THE ECONOMIC RECOVERY TAX ACT. WHILE, THEORETICALLY, I APPLAUD SUCH MEASURES, I MUST EXPRESS RESERVATIONS ABOUT ANY NEW TAX PROVISIONS THAT REDUCE REVENUES AT THIS TIME. WHEN A BURGEONING DEFICIT FORCES US, ON THE REVENUE

SIDE, TO LOOK FOR BLOOD FROM TURNIPS, I CANNOT ADVOCATE GIVING ANY TAXPAYER A FREE TRANSFUSION.

THE SECOND BILL TO BE CONSIDERED TODAY, S. 2281, IS THE SORT OF SPECIALLY TARGETED TAX BILL THAT WE MUST SCRUTINIZE VERY CAREFULLY THIS YEAR. ON ITS FACE, IT SEEMS TO BE A GREAT IDEA TO ENCOURAGE COMPUTER MANUFACTURERS TO GIVE COMPUTERS TO SCHOOLS, EVEN THOUGH THE MANUFACTURER MAY DERIVE SUBSTANTIAL BENEFITS FROM SERVICE CONTRACTS, FUTURE SALES, AND SO ON. BUT WE MUST BE CAREFUL THAT THE CONTRIBUTION BE PAID FOR JOINTLY BY THE TREASURY AND THE MANUFACTURER, NOT SOLELY BY THE TREASURY.

AS PRESENTLY DRAFTED, IF A CONTRIBUTOR MAKES A CONTRIBUTION OF INVENTORY UNDER THE TWICE BASIS LIMITATION, THE TREASURY, IN ESSENCE, BUYS THE INVENTORY AT COST OR AT 92% OF COST AT LEAST. THE "CONTRIBUTION" MADE BY THE MANUFACTURER IS NEGLIGIBLE. GIVEN THE FUTURE BENEFITS THE MANUFACTURER COULD RECEIVE FROM HIS "CONTRIBUTION", I THINK IF WE DO ANYTHING AT ALL WITH THIS BILL, THAT WE SHOULD SCRUTINIZE THIS TWICE BASIS LIMITATION TO SEE WHETHER A LOWER LIMIT MIGHT NOT MAKE THE CONTRIBUTION LESS OF A ONE-SIDED GIFT.

Senator PACKWOOD. Are there any other questions of the Secretary?

[No response.]

Senator PACKWOOD. If not, Mr. Secretary, thank you very much.

Secretary CHAPOTON. Thank you, Mr. Chairman.

Senator PACKWOOD. I would place in the record at this stage a statement from the American Council for Capital Formation, which is basically supportive of S. 2214.

[The prepared statement follows:]

AMERICAN COUNCIL FOR CAPITAL FORMATION

May 6, 1982

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation
and Debt Management
Senate Committee on Finance
Washington, D.C. 20510

Dear Mr. Chairman:

As volunteer Chairman of the American Council for Capital Formation, I appreciate the opportunity to present the views of the American Council on the need for stronger incentives for personal saving and, specifically, on the Savings and Investment Incentives Act of 1982 (S.2214) introduced by you and Senators Harrison Schmitt, Steven Symms, Charles Grassley and Mack Mattingly.

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 businesses, 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.

We strongly support enactment of S.2214. This measure would encourage higher levels of personal saving by increasing the aftertax return on interest and dividend income. In addition, the bill would reduce the bias in our tax system toward consumption by eliminating the deductibility on interest payments for certain types of consumer loans. Specifically, the bill would promote saving and capital formation in the following ways.

- o S.2214 would broaden the current law definition of income eligible for the exclusion to include dividends and certain additional forms of interest. This would add a measure of neutrality to decisions regarding saving and investing.

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- S.2214 would encourage saving because the aftertax rate of return on the marginal dollar of investment would be higher for people whose dividend and interest income is less than $2,000 per year ($4,000 for a married couple). Average aftertax rates of return would be higher for taxpayers whose interest and dividend income exceeds $2,000 (or $4,000 for a married couple) per year.

- S.2214 would reduce the tax bias toward consumption by eliminating the tax deductibility of some consumer interest on debt and by requiring that income eligible for the exclusion be reduced by interest incurred on most debts except a dwelling unit and loans for business activities.

- S.2214 would reduce the discrimination against low income taxpayers who do not itemize by eliminating the deductibility of consumer interest payments for items other than mortgages, cars, higher education expenses or investment-related expenses.

- S.2214 would increase Treasury revenues in the outyears. The revenue pickup stems from the gradual elimination of the deductibility of all but qualified interest expenses.

The American Council for Capital Formation strongly urges the passage of the Savings and Investment Incentives Act of 1982 because, by stimulating saving and reducing the bias toward consumption, S.2214 would help increase the availability of capital to finance needed investment. We believe that the level of saving and investment which was adequate in the past is no longer sufficient to reverse the decline in productivity and economic growth experienced in the United States since the early 1970's. First, each additional dollar of gross investment yields less <u>net</u> investment because our capital stock is depreciating more rapidly, in part due to higher energy prices which have made much of the stock obsolete. Much of our capital stock was put in place before the surge in energy prices which occurred in 1973 and 1980. Sharply higher energy prices have made a significant portion of our capital stock (both plant and equipment) obsolete and in need of replacement. Second, another reason for the more rapid depreciation of the capital stock in the 1970's is that much recent investment has been in relatively short-lived equipment, which adds little to long-term productivity.

Another factor which produces a need for higher than historical levels of investment spending is that the capital-labor ratio declined in the 1970's. Generally, increases in the capital-labor ratio are associated with increased productivity because: (1) production processes which yield more output per worker usually require more capital per worker and (2) increasing the capital-labor ratio involves putting technologically superior new capital in place. The major factors contributing to the decline in capital-labor ratios in the 1970's appear to be: (1) rising energy prices; (2) the allocation of large amounts of resources to meet government mandated pollution control requirements; and (3) the entry of many inexperienced young workers and women into the work force.

In summary, the historical level of investment in the U.S. is no longer adequate to permit increases in economic growth and productivity. In order to finance higher levels of capital formation in the future, as well as to provide for government mandated programs such as pollution control, we must increase the pool of savings which makes investment possible. Given the economic shocks and stresses to which our economy has been subjected since the 1970's, only an increase in the rate of saving and productive capital formation can lead to the goal of higher living standards for all Americans.

Sincerely,

Charls E. Walker
Chairman, American Council
for Capital Formation

Senator PACKWOOD. We will now start with our first panel, a panel consisting of Mr. Edward Sprague, the Director for Tax Policy of the Tax Foundation in Washington; and Mr. David G. Raboy, Director of Research, Institute for Research on the Economics of Taxation.

Are you ready, Mr. Sprague?

Again, I would emphasize to all of the witnesses that I had a chance to read all of your statements en toto. You were very good about getting them in prior to the hearings. We will hold ourselves to 5 minutes of direct testimony. Your entire statement will be in the record, and I think you can tell from the committee that there is a fair degree of interest in wanting to ask questions.

STATEMENT OF EDWARD A. SPRAGUE, DIRECTOR, TAX POLICY, TAX FOUNDATION, WASHINGTON, D.C.

Mr. SPRAGUE. Thank you, Senator Packwood.

I am Ned Sprague, director of tax policy for the Tax Foundation, which is a nonprofit research and public education foundation monitoring fiscal aspects of government at all levels. I am pleased to present a very brief statement on S. 2214, the Savings and Investment Incentive Act.

In our view there is little question that overall S. 2214 offers a better savings incentive than present treatment or under the Economic Recovery Tax Act provision which is scheduled for 1985.

In spite of what Buck Chapoton said about the slightly lower cap on the net interest exclusion, we feel that a 25-percent rate applying to most institutional sources of interest income would increase the attraction of savings versus consumption at the margin for many taxpayers. And, most important, of course, when you include dividends subject to these new higher limits, the marginal benefits would be quite significant where the bulk of the savings is done, up the ladder.

Reduction of tax obstacles to savings investment is a recognized national need, as you all know, and the principal objective of last year's tax bill. And any measure that furthers that objective and at the same time projects a believable gain to the Treasury in a time of great concern over deficits and all certainly merits the close attention of these subcommittees and Congress. So I would give S. 2214 pretty high marks on this central policy issue.

There are some other things to consider, and I will just tick them off very briefly.

In one respect, 2214 would shift the benefit higher on the income scale. The taxpayers with very little dividend income would get the smaller exclusion than at present. Upper income groups who receive the bulk of dividend income would get most of the benefit.

On the other hand, the bulk of taxpayers in the low-middle and middle-income brackets who do not itemize would still get the benefit of the higher interest exclusion, would not have to net out any interest payments, and would not be affected by the phaseout of consumer interest expense deductions.

I'm not sure how all these shifts would filter out in terms of the overall distribution of tax burdens, but it wouldn't seem to involve any overwhelming problem of equity.

Secondly, most tax economists, at least, feel that the present dividends-received exclusion, which has now reverted to $100 to $200, doesn't offer much of a savings incentive, and certainly not much of an offset against the double taxation of dividends in the present system. Raising this exclusion to a maximum of $500 to $1,000 subject to the 25 percent could help in both respects. It wouldn't solve the double taxation issue by any means, but past attempts to do so, to provide some partial integration of the corporate and individual income tax, have fallen so flat that perhaps only a relatively easily implemented measure such as raising the exclusion is feasible.

Now, under S. 2214, interest payments on mortgages, business and investment loans, education and auto loans would remain deductible whereas consumer interest would not. It would be phased out. And, from a tax policy viewpoint, it is somewhat difficult to justify this different treatment. I know you are going to hear a lot about that from the other witnesses later on, particularly of course on the impact between different financial institutions, on auto loans versus other consumer credit, a significant part of which finances purchases of other consumer durables.

Now, the deductibility of interest expense undoubtedly is less of a factor in the total cost and purchase plans for nonauto consumer durables than it is for autos financed over a longer period. But, obviously, there is an element of both discrimination and complication here. I think Buck Chapoton went into that in sufficient detail, so I won't attempt to review that.

I would mention one potential problem of compliance that he didn't address. Under either present law or S. 2214, to benefit from the interest-received exclusion taxpayers making itemized deductions must subtract their interest paid, except for that incurred for business and residential property loans. Now, if interest expense is still deductible on itemized returns, there is sort of a self-enforcing mechanism to report such interest. If you eliminate most of the consumer interest deduction you will lose that self-enforcing mechanism, and some taxpayers undoubtedly will be tempted not to report in order to maximize an exclusion. I am not sure this is a significant problem, and I don't think it is as significant as some of the other things that Buck Chapoton mentioned, but I would mention it as something that would have to be addressed.

In summary, I think that the bill would certainly make a quite positive contribution to our capital formation objectives with the added attraction of a potential revenue pickup to the Treasury. Now, there are other policy matters that need to be explored, particularly the administrative and compliance issues, but in our initial view at least these problems would seem to be manageable. We would defer to the Treasury and others for a closer study on those.

Thank you.

Senator PACKWOOD. Mr. Raboy?

STATEMENT OF DAVID G. RABOY, DIRECTOR OF RESEARCH, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, D.C.

Mr. RABOY. Thank you, Senator.

My name is David Raboy. I am the director of research for the Institute for Research on the Economics of Taxation. IRET is a nonprofit organization that conducts research in the free market mode concerning Government spending, taxing, and monetary policies.

The point of departure for my analysis is in general the belief that the market provides the best mechanism for the efficient allocation of resources. Since the market sometimes fails to direct resources to preferred uses, a limited role for Government is warranted, and revenues must be raised to fund legitimate Government activity; but these revenues should be raised in ways that least distort market signals. I don't believe it is the role of the Tax Code to target economic activity, or it shouldn't be.

Now, such concepts are embodied in the term "tax neutrality." Under a neutral tax system economic actors would make their decisions without reference to the code.

No perfectly neutral system is attainable, but policymakers would be well advised to implement legislation that increases the neutrality of the code.

It is in this context, the context of tax neutrality, that I will consider S. 2214.

Economists have long recognized that the U.S. Tax Code artificially depresses savings and encourages borrowing. In fact, the greatest nonneutrality in our Tax Code concerns the tax treatment of income from capital sources. In the first place, all savings come out of after-tax dollars. To add an additional layer of tax on top of the original tax as is true under current law serves to encourage current consumption, which is taxed once, at the expense of saving for future consumption, which is taxed twice.

Under current law some types of savings are tax preferred. Also, interest costs are fully deductible, and this raises the possibility for tax arbitrage. We've seen some of this.

In general, the Tax Code, through this interest deductibility, creates an artificially high level of credit demand, and these effects are exacerbated by the interaction of inflation and the nominally denominated Tax Code.

In inflationary periods, borrowing may actually be subsidized while savings may bear a negative return.

One of the greatest problems facing us today is the specter of stubbornly high interest rates. An interest rate is the competitively determined price of credit. It is the amount that savers need to forgo the current use of resources, and it is the amount that borrowers are willing to pay to have funds available sooner. Anything that increases the demand for credit or borrowing or decreases credit supply or saving will exert upward pressure on interest rates. And I believe the tax-related distortions are a partial explanation of high interest rates.

Economic decisionmaking occurs at the margin. Whether I save additional income or spend it depends in part on the tax treatment of those incremental or marginal dollars.

The tax treatment of dollars already saved will not affect my decision on incremental income. Thus, the relevant policy variable for savings behavior is the marginal rate of tax on income from saving.

Greater neutrality can be achieved by decreasing the marginal rate of tax on income from saving and by eliminating the marginal tax benefit of borrowing. This is exactly what S. 2214 does.

In my written statement I provide a table showing the effects on marginal rates of S. 2214, the Economic Recovery Tax Act of 1981, and the pre-Tax Act law.

In general, S. 2214 results in substantially decreased marginal rates on income from savings, but there is a caveat. Policymakers should be very careful when attaching the cap to a savings bill. In prior laws the $200 to $400 exclusion was ineffective, because many savers had savings income in excess of this cap. Since additional income suffered the full marginal tax rate, there was no incentive to save additional dollars.

Under S. 2214 certain savers will reach the cap relatively quickly and will lose the extra incentive to save. This is because of the interaction of the 25-percent exclusion and the cap. In order to maintain the marginal benefits, if revenue loss is a constraint, a slightly lower percentage exemption may be traded against the higher cap. But this is a matter to be studied.

In general, S. 2214 would be a major step toward increasing the neutrality of the Tax Code. It would result in a higher savings rate, lower interest rates, stronger investment and economic efficiency.

Thank you, Senator.

[The prepared statements of the previous panel follow:]

STATEMENT OF EDWARD A. SPRAGUE
ON BEHALF OF THE TAX FOUNDATION, INC.
ON S.2214 (THE SAVINGS AND INVESTMENT INCENTIVE ACT)
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
AND THE SUBCOMMITTEE ON SAVINGS, PENSIONS & INVESTMENT POLICY
OF THE COMMITTEE ON FINANCE, U.S. SENATE

Friday, May 7, 1982

Summary

S.2214 could make a quite positive contribution to our capital formation objectives with the added attraction of a potential revenue pickup to the Treasury. There are some other policy matters that need to be explored further, including the distributional effect of the measure and a possible compliance problem. In our initial review, any problems in these areas seem managable.

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I'm Edward A. Sprague, Director, Tax Policy of the Tax Foundation, which is a non-profit research and public education foundation monitoring fiscal aspects of government at all levels. I am pleased to present a brief statement on S.2214, the Savings and Investment Incentive Act.

The heart of S.2214 is a significant expansion and acceleration of the net interest exclusion scheduled to go into effect in 1985. S.2214 would advance the effective date to July 1982, increase the exclusion on net interest from 15% to 25%, increase the dollar ceilings from $450-$900 to $500-$1,000 (on single and joint returns, respectively). It also would apply these higher limits to the dividends received exclusion. To finance this liberalization and reinforce the incentive for savings, the deduction for most consumer interest expense would be phased out ending entirely in 1985.

According to the Joint Committee on Taxation, the revenue effect of S.2214 on the Treasury would be negative in the first two fiscal years, but turn positive by fiscal 1984, and then generate some significant surpluses going out into the latter 1980s. These estimates are made on the traditional initial impact basis and presumably do not depend on any specific response within the economy. Presumably the measure could be adjusted to make the revenue effect neutral in fiscal 1982 and 1983 if necessary for budget purposes.

There is little question that S.2214 offers a better savings incentive than under The Economic Recovery Tax Act provision scheduled for 1985, and much better than the present treatment. A 25% net interest exclusion applying to most institutional sources of interest income should increase the attraction of savings versus consumption appreciably at the margin. As you know, reduction of tax obstacles to savings and investment is a recognized national need and a principal objective of ERTA. Any measure that furthers that objective, and at the same time, projects a believable potential gain to the Treasury in this time of great concern over federal deficits, certainly merits careful consideration by this Subcommittee and Congress. I would give S.2214 high marks on this central and critical policy issue.

There are some other policy matters to consider, of course:

1. In one respect, S.2214 would shift the tax benefit higher on the income scale--where most savings take place--by applying a 25% rate to the dividends received exclusion while increasing the ceiling to $500-$1,000. Taxpayers with very little dividend income obviously would get a smaller exclusion than under present law. Upper income

groups who receive the bulk of dividend income would get most of the benefit. On the other side, the bulk of taxpayers in the low-middle and middle income brackets who do not itemize would still get the benefit of the higher interest exclusion, would not have to net out any interest payments, and would not be affected by the phase-out of consumer interest expense deductions. I'm not sure exactly how these shifts would affect the overall distribution of tax burdens by income class, but they would not seem to involve any significant problem in equity of distribution.

2. Most tax economists feel that the present dividends received exclusion, which has reverted to a $100-$200, doesn't offer much of a savings incentive and certainly not much of an offset against the double taxation of dividends in the present system. Raising the exclusion to a maximum of $500-$1,000 subject to the 25% limit could help in both respects. It certainly wouldn't solve the double taxation issue, but past attempts to provide some integration of corporate and individual income taxes have fallen so flat that perhaps only an easily implemented measure such as raising the exclusion per S.2214 is feasible.

3. Under S.2214, interest payments on residential mortgages, business and investment loans, and education and auto loans would remain deductible. From a tax policy viewpoint, it's somewhat difficult to justify the different treatment, particularly for auto loans versus other consumer credit, a significant part of which finances purchases of other consumer durables. The deductibility of interest expense undoubtedly is less of a factor in the total cost and purchase plans

for non-auto consumer durables than it is for autos financed over a longer period. Obviously, however, there is an element of discrimination here which may be inevitable for purposes of implementing the basic reform.

4. Finally, there is one potential problem of compliance that should be addressed, at least. Under either present law or S.2214, to benefit from the interest received exclusion taxpayers making itemized deductions must subtract their interest paid, except for that incurred for business and residential property loans. With interest expense still deductible on itemized returns there is, of course, a self-enforcing mechanism to report such interest paid. If the deduction for most consumer interest expense is eliminated you lose that automatic enforcement mechanism. Some taxpayers will be tempted not to report their interest paid in order to maximize the net exclusion. I'm not sure that this really would be a significant problem, but in these times of increasing concern over tax compliance, it should be addressed. I might add that the same problem, of course, could arise later under the present ERTA provision if, for budget reasons, there is a movement to eliminate or limit the consumer interest expense deduction.

In summary, I believe S.2214 could make a quite positive contribution to our capital formation objectives with the added attraction of a potential revenue pickup to the Treasury (on the traditional initial impact basis for measuring revenue change). There are some other policy matters that need to be explored further, including the distributional effect of the measure and a possible compliance problem. At least in our initial review here, any problems in these areas seem managable.

STATEMENT BY DAVID G. RABOY, DIRECTOR OF RESEARCH FOR THE INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)

My name is David Raboy and I am the Director of Research for the Institute for Research on the Economics of Taxation (IRET). IRET is a non-profit organization that was founded in 1977 by Dr. Norman B. Ture, who is now the Undersecretary of the Treasury for Tax and Economic Affairs. The Institute conducts research in a free-market mode concerning government taxing, spending, and monetary policies.

Proper Resource Allocation

The point of departure for this analysis is the understanding that the market system provides the best mechanism for the efficient allocation of scarce resources. Through the pricing mechanism, the market sends signals to workers, savers, consumers, and producers as to what to produce and how much of it; through market signals individuals determine how much they should consume now, and how much they should save for future consumption.

As a general principle, government activities that distort the flow of information that the market provides--policies that confuse the relative costs or benefits facing economic actors--necessarily result in a decrease in the nation's economic well-being. Such noise leads to a wasting of scarce resources. It is recognized that sometimes the market will fail to direct resources to their preferred uses, and in such cases government economic intervention may be necessary, but only if it can be demonstrated that intervention will not do more harm than good.

Tax Neutrality

The purpose of a tax system is to raise necessary government revenues while doing the least amount of damage to the market mechanism. The principle of tax neutrality stresses that tax policy should not be used to direct economic activity nor to achieve social goals. Under a neutral tax regime economic actors would make their decisions without reference to the tax code. Thus, resources would be distributed in a way that yields the greatest benefits to society.

Every tax has the effect of altering the costs or rewards facing individuals. This is obvious in the case of an excise tax on, say, gasoline. It alters the cost that consumers must pay for gasoline relative to all other items that they may wish to consume. But this "relative price" or "relative benefit" distortion is not limited to excise taxes. It is possible that a system of income taxes may distort choices concerning how much to save and how much to work.

When taxes distort market signals, individuals may make inferior, uneconomic decisions. They may do things that they normally would not, absent the tax-induced distortion. Such distorted decision making leads to a decrease in satisfaction for the individual and a decrease in economic efficiency for society. Therefore, society should strive to raise revenues in as neutral a way as possible. No perfectly neutral tax system exists, but policy makers should strive to produce a tax system that least distorts decision making.

Saving Behavior

Economists have long recognized that the U.S. tax code artificially depresses saving and encourages borrowing. In fact, the greatest non-neutrality in our tax code concerns the tax treatment of income from capital sources. This non-neutrality occurs for several reasons.

1) The nature of income taxes: The original intent of policy makers was to build a pure income tax system which was defended on equity grounds. The economist's definition of net income in any year was the algebraic sum of consumption plus the change in a taxpayer's net worth. Since interest payments were a net decrease in the taxpayer's net worth, they were deducted from the income tax base while interest income and dividend income, which went either to consumption or investment, were taxed.

The point that was missed in this definition is that savings had already been taxed once, since all saving was out of after-tax dollars. Thus, even a pure income tax system results in a double taxation of saving. This is not neutral because it artificially encourages borrowing and discourages saving--resulting in an undesirably low saving rate. Without this distortion the market would lead to higher levels of saving.

2) Our "hybrid" tax system: Our current system is a mixture of income and "expenditure" taxes. Under an expenditure tax system, all income would be taxed only once and thus there would not be the borrowing/saving distortion. Under current law some saving instruments enjoy preferred tax treatment while borrowing costs are still deductible. This leads to possibilities for "tax arbitrage" where funds are borrowed and invested in tax-preferred investments and the taxpayer still enjoys the deduction of interest payments.

3) Inflation and the nominal tax system: The problems stated above are exacerabated in that the tax code was not designed for inflationary times. In an inflationary period, since a borrower can deduct the full nominal value of interest payments, the net result may be the government's actual subsidation of borrowing. Similarly, since the saver is taxed on nominal earnings, after taxes the return to saving will be very low or even negative. Further, changing inflation rates will lead to constantly changing effective tax rates; the result being a substantial risk factor which further depresses saving.

The Economic Effects of Current Taxes on Saving

An interest rate is the competitively determined price of credit. The rates quoted every day represent what borrowers are willing to pay to have funds available sooner, and what savers demand in order to forgo use of those funds. All else held constant, anything that increases the demand for credit (borrowing) will exert upward pressure on interest rates as will anything that decreases the supply of credit (saving). Our tax code artificially decreases supply and increases demand. Tax-related issues are a partial explanation of currently observed high interest rates. Reform of the tax system would serve to decrease interest rates.

Towards a Neutral Tax System

A neutral tax system would not artificially encourage borrowing or discourage saving. Motion towards a neutral tax system would be in the form of lowering the marginal rate of tax on income from saving and decreasing the tax-induced marginal benefit of borrowing. It is the tax treatment of marginal dollars that matters, because the costs and benefits of saving additional dollars determines whether those dollars will be saved, not the treatment of dollars in the past.

An ingenious proposal has been advanced by Professors Alvin Rabaskka and Robert E. Hall of Stanford University. This proposal has become embodied in S 2198, introduced by Senator DeConcini, and would produce a simple system that is neutral with respect to the savings decision. But for political reasons the Hall-Rabashka proposal is probably a good way down the road. In the interim, Congerss should adopt legislation that increases the neutrality of the code. Such a bill is S 2214.

S 2214

This bill would phase out the tax-induced bias which favors borrowing, and would take a large step towards decreasing the marginal rate of tax on income from saving by increasing the percentage interest exemption included in the Economic Recovery Tax Act (ERTA) from 15 to 25 percent. It would also speed up the effective date.

Under current law, borrowing is subsidized by the American personal income tax. This occurs because those who itemize their deductions can reduce their taxable income dollar for dollar with their interest expenses. Moreover, the subsidy increases when one's taxable income rises. As an example, compare a married couple that has a taxable income of $18,000 with a couple whose taxable income is $55,000. In 1982, the first couple owes 22 cents in taxes on its last dollar of taxable income, while the second couple owes 44 cents. If both claim itemized interest expenses of $1,000, the first couple reaps a $220 tax reduction while the more prosperous couple gains $440.

The interest deduction is not fair. It is also inefficient. The tax system encourages Americans to borrow rather than save because it reimburses them for part of their borrowing expense. Even worse, individuals in high brackets, who have the greatest ability to save, are those with the highest tax incentive not to save. This helps explain why the United States has the lowest personal savings rate in the industrial world: Americans are responding to the incentives created by their individual income tax. In the United Kingdom, often cited as an economic sluggard, personal saving amounted to 15.3 percent of disposable personal income in 1980. The comparable ratio in the United States was only 5.6 percent.* Inefficiency is a serious charge because it implies lower productivity, slower growth, less improvement in living standards, and a decline in America's economic status relative to other nations.

Against this backdrop, S 2214's phased removal of the deductibility of consumer credit interest charges is both efficient and equitable. (Loans for home mortgages, autos, higher education, and business activities are exempted.) The act removes the government from the business of supporting and thereby encouraging consumer borrowing. Individuals will be better able to save or borrow based on the merits of the case without having to look over their shoulders at the arbitrary incentives of the tax system. Because the withdrawal of deductibility occurs gradually, people

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*Statistical Abstract of the United States, 1981 Bureau of the Census, Government Printing Office, Washington, D.C., 1981, Table No. 717.

will have time to adjust their behavior to it. Thus any transitional problems should be slight.

Whereas the personal income tax allows itemized deductions for interest charges incurred by borrowers, it assesses taxes on the interest, dividends, and capital gains earned by savers. As a result, the tax system penalizes saving at both ends: it subsidizes those who dissave while taxing those who do save. For an especially striking instance of this, return to the couple mentioned earlier who have a taxable income of $55,000 in 1982 and thus find themselves in the 44 percent marginal tax bracket. If this couple borrows and has interest charges of $1,000 before tax, their after-tax expense is only $560. But if this same couple decides to save, puts its funds in a non-All-Savers bank account and earns $1,000 in pre-tax interest income, its after-tax reward is only $560. If the government tried to pursue a deliberate policy of discouraging saving, it would be hard pressed to do a better job than this.

Notice that the example looks at marginal, not average, tax rates. This is no accident. Marginal rates are the ones that count when people make decisions with tax consequences. This distinction becomes crucial later when the tax treatment of savings income under present law and S 2214 is compared. The relevance of marginal rather than average rates can be brought into focus by constructing two purely hypothetical personal income tax systems. In system one, the tax rate is zero on the first $20,000 of taxable income and 99 percent on the remainder. In system two, the tax rate is 20 percent on the first $20,000 of taxable income and 30 percent on the rest. Now place on the scene a taxpayer who earns $20,000 of taxable income from his labor services and has accumulated $6,000 of savings. The savings can either by spent on present consumption or reinvested to earn, say, $1,000 pre-tax.

The first system has an average rate of tax between 0 and 4.7 percent, depending upon how much of saving is reinvested, but a marginal tax rate of 99 percent. The second system has an average tax rate of between 20 and 20.5 percent, but a marginal tax rate of only 30 percent.

If average rates govern the choice between saving and not saving, the first system, with its extremely low average rate, should generate far more saving than the second. But this is an absurd result. It implies that people are more inclined to continue saving when the income added by saving is taxed at 99 percent than when it is taxed at 30 percent. The trouble with average rates is that they lump together the tax treatment of all income, from the first dollar to the last. A more sensible approach for the individual is to ask how much saving adds to after-tax income when it is reinvested. The answer, based on tax rates at the margin, is that $1,000 of reinvested savings contributes only $10 after-tax under system one, but $700 after-tax under system two.

Even if the deductibility of borrowing charges were repealed, the taxation of savings income would still distort the economic choices of individuals. To see why, consider an individual who has just earned some amount of labor income. If there were no taxes, the individual could allocate his income between two basic uses: present consumption and future consumption (i.e., present saving). The choice would be guided by economic criteria like one's desire for present enjoyment versus the value to society (expressed by the interest rate) of postponing own consumption and lending to others, one's wish to maintain a moderately even living standard during both working years and retirement, and the trade-off between own consumption and providing resources for one's heirs.

Now introduce a personal income tax on earnings from both labor and saving. It is first levied on labor income. That reduces the reward for work and may diminish the labor supply, but it does not, by itself, bias the choice between present and future consumption. However, this tells only half the story, for the two types of consumption are treated differently. If the after-tax labor income is channeled into present consumption, it undergoes further taxation. Personal income tax systems rarely tax the implicit income stream derived from consumption. In contrast, saving for future consumption subjects an individual to a second layer of taxation: the levy on savings income. In short, the introduction of the personal income tax imposes one round of taxation on immediate consumption, but two rounds on future consumption. That second level of taxation is what biases the saving decision. In effect, present consumption becomes a tax shelter because it avoids this double taxation.

From the point of view of lessening the distortions created by the personal income tax, the major accomplishment of ERTA lay in reducing marginal tax rates on personal income from all sources. As marginal rates decline, so does their ability to warp individual decisions. ERTA lowers marginal rates through the 1984 tax year and indexes them to inflation thereafter. One must concede, however, that the reductions are largely needed to offset bracket-creep, the process in which inflation pushes people with constant real incomes into higher tax brackets. Tables 1 to 3, which appear at the end of this testimony, show the decline in marginal brackets for several hypothetical taxpayers. For example, a single taxpayer who has a taxable income of slightly over $15,000 was in the 30 percent marginal bracket previously. Under ERTA, that drops to 27 percent in the 1982 tax year and 23 percent by 1984. (See Table 2).

The old law allowed a \$200/\$400 (single/joint return) exclusion for interest and dividend income. This lowered average taxes, but had a limited marginal impact. For very small savers, like the individual represented in Table 1 who has only \$1,000 in savings, the incentive was strong. The marginal tax rate on interest and dividend income dropped to zero. However, if the market interest rate is 12 percent, a single individual reached the cap when his savings hit \$1,666.67 (\$3,333.33 for a married couple). Beyond that level, interest and dividend income were exposed to the full marginal tax rate. They gained no relief from the double taxation of savings. Table 2 depicts this case. It is based on a single individual who has savings of \$3,000 which yields a 12 percent return, and taxable income from other sources of \$15,000.

ERTA replaced this exclusion with several others: 1) a \$100/\$200 dividend (but not interest) exclusion for tax years 1982 through 1984; 2) a 15 percent net interest (but not dividend) exclusion, with a cap of \$450/\$900, beginning in tax year 1985; and 3) several exemptions targeted to special types of saving, like All-Savers Certificates and domestic public utility stock dividend reinvestment plans. In terms of incentives, the first and last categories have mixed effects. The dividends exclusion is a slight step backward. Table 1 shows that the marginal rate on dividends and interest income jumps dramatically for some very small savers. The special exemptions attempt to direct savings toward specific goals. Because the favored investments appeal to only a minority of savers, the stimulus they provide to the overall savings rate is likely to be small.

The 15 percent net interest exclusion has greater potential. It continues to have a marginal effect for levels of interest income far beyond that eligible for the pre-

ERTA exclusion. Table 2a shows this for a single individual with $360 of interest income and taxable income from other sources of $15,000. Under prior law, the last dollar of interest income was taxed at 30 percent. Under ERTA, the marginal tax is cut almost in half, to 15.3 percent. This percent is calculated by finding the tax bracket of the last dollar of taxable income (18 percent) and multiplying it by the taxable fraction of the last dollar of interest income (.85). Thus,

$$15.3\% = 18\% \times .85.$$

Comparing ERTA with prior law, note that the change in tax brackets reduces the marginal rate on interest income by 40 percent. The 15 percent exclusion decreases it by 9 percent more.

An excellent qualification attached to the 15 percent exclusion is that it only applies to net interest income. Thus if a taxpayer has $2,000 of interest income but $1,600 of itemized deductions for consumer credit interest expenses, the amount on which the 15 percent exclusion may be taken falls to $400. Interest expenses (interest on home mortgages and business loans excepted) must be subtracted in computing net interest. Although this procedure does not erase the tax system's subsidy to borrowers, it does lessen that subsidy, and thereby makes the tax climate for saving slightly less hostile.

An unfortunate feature ~~of ERTA, obvious~~ from Table 2a, is that interest income bears the full marginal tax rate until 1985. Its exemption does not begin until two and one half years from now. Table 2b highlights another drawback. Starting in 1985, dividend income receives no relief from the double taxation of savings. The

$100/$200 dividend exclusion expires at the end of 1984, and no percentage exclusion replaces it. Curiously, ERTA slightly favors dividend income for tax years 1982 through 1984, but switches its concern to interest income in 1985 and thereafter. A less distortionary approach would be to treat these two general forms of savings income equally. Then individuals could choose between them without experiencing an artificial tax incentive.

S 2214 corrects the bulk of the problems mentioned above. It also streamlines the treatment of interest and dividend exemptions. In place of ERTA's immediate $100/$200 dividend exclusion and eventual 15 percent interest exclusion, it permits an immediate 25 percent yearly exclusion (12.5 percent in 1982) on both net interest and dividends, up to a maximum exemption of $500/$1,000. One clear advantage is that the most powerful corrective measure begins almost at once. It will have been in place for two and one half years before ERTA's 15 percent interest exemption begins. A second positive feature is that S 2214 treats interest and dividend income equally, avoiding a potential source of distortions. A third advantage is that, until its cap is reached, S 2214's 25 percent interest and dividend exemption comes closer than ERTA's exemptions to removing the income tax system's bias against saving. Tables 1 and 2 show that S 2214 reduces marginal tax rates on saving sooner, more deeply, and more evenly (as between interest and dividend income) than does ERTA.

Table 3 suggests one of the few defects in this bill. Once the cap is reached, the marginal incentive for additional saving disappears. Thus neither S 2214 nor ERTA provides much extra motivation for large savers. Under some circumstances S 2214 reaches its cap at a lower level of savings than does ERTA. For 1985 and beyond, ERTA lowers marginal tax rates on the first \$3,000/\$6,000 of interest income. However S 2214, which has a much larger percentage exemption but only a slightly higher cap, exerts an incentive on just the first \$2,000/\$4,000 of interest and dividend income. The last two rows of Table 3 show that ERTA may be more effective than S 2214 when savings income falls between \$2,000 and \$3,000 for a single tax return (and between \$4,000 and \$6,000 for a joint return).

Table 1a

Filing Status : Single

Taxable Income NOT from Interest or Dividends : $15,000

Amount of Savings : $1,000

Interest or Dividends : $120 (Interest Rate = 12 %)

Year	Savings Exemption	Total Taxable Income	Marginal Tax Bracket	Marginal Tax Rate on Savings
1982: Pre-ERTA[a]	$120	$15,000	26%	0%
ERTA	0	15,120	27	27
§ 2214	15	15,105	27	23.6
1983: Pre-ERTA	120	15,000	26	0
ERTA	0	15,120	24	24
§ 2214	30	15,090	24	18
1984: Pre-ERTA	120	15,000	26	0
ERTA	0	15,120	23	23
§ 2214	30	15,090	23	17.2
1985: Pre-ERTA	120	15,000	26	0
ERTA[c]	18	15,052	20	17
§ 2214	30	15,040	20	15

[a] Assumed that $200/$400 exemption would have been extended.

[b] Cap on saving exemption reached.

[c] Indexing adjustment assumes 5% inflation and 1 exemption(s).

Assumed that amount of savings and income from other sources are constant.

Assumed that interest deductions are zero.

Table 1b

Filing Status : Single

Taxable Income NOT from Interest or Dividends : $15,000

Amount of Savings : $1,000

Interest or Dividends : $120 (Interest Rate = 12 %)

Year	Savings Exemption	Total Taxable Income	Marginal Tax Bracket	Marginal Tax Rate on Savings
1982: Pre-ERTA[a]	$120	$15,000	26%	0%
ERTA	100[b]	15,020	27	27
S 2214	15	15,105	27	23.6
1983: Pre-ERTA	120	15,000	26	0
ERTA	100[b]	15,020	24	24
S 2214	30	15,090	24	18
1984: Pre-ERTA	120	15,000	26	0
ERTA	100[b]	15,020	23	23
S 2214	30	15,090	23	17.2
1985: Pre-ERTA	120	15,000	26	0
ERTA[c]	0	15,070	20	20
S 2214	30	15,090	20	15

[a]Assumed that $200/$400 exemption would have been extended.

[b]Cap on saving exemption reached.

[c]Indexing adjustment assumes 5% inflation and 1 exemption(s).

Assumed that amount of savings and income from other sources are constant.

Assumed that interest deductions are zero.

Table 2a

Filing Status : Single

Taxable Income NOT from Interest or Dividends : $15,000

Amount of Savings : $3,000

Interest : $360
or
Dividends : (Interest Rate = 12 %)

Year	Savings Exemption	Total Taxable Income	Marginal Tax Bracket	Marginal Tax Rate on Savings
1982: Pre-ERTA[a]	200[b]	$15,160	30%	30%
ERTA	0	15,360	27	27
§ 2214	45	15,315	27	23.6
1983: Pre-ERTA	200[b]	15,160	30	30
ERTA	0	15,360	24	24
§ 2214	90	15,270	24	18
1984: Pre-ERTA	200[b]	15,160	30	30
ERTA	0	15,360	23	23
§ 2214	90	15,270	23	17.2
1985: Pre-ERTA	200[b]	15,160	30	30
ERTA[c]	54	15,256	18	15.3
§ 2214	90	15,220	18	13.5

[a] Assumed that $200/$400 exemption would have been extended.

[b] Cap on saving exemption reached.

[c] Indexing adjustment assumes 5% inflation and 1 exemption(s).

Assumed that amount of savings and income from other sources are constant.

Assumed that interest deductions are zero.

Table 2b

Filing Status	:	Single
Taxable Income NOT from Interest or Dividends	:	$15,000
Amount of Savings	:	$3,000
Interest or Dividends	:	$360

(Interest Rate = 12 %)

Year	Savings Exemption	Total Taxable Income	Marginal Tax Bracket	Marginal Tax Rate on Savings
1982: Pre-ERTA[a]	200[b]	$15,160	30%	30%
ERTA	100[b]	15,260	27	27
§ 2214	45	15,315	27	23.6
1983: Pre-ERTA	200[b]	15,160	30	30
ERTA	100[b]	15,260	24	24
§ 2214	90	15,270	24	18
1984: Pre-ERTA	200[b]	15,160	30	30
ERTA	100[b]	15,260	23	23
§ 2214	90	15,270	23	17.2
1985: Pre-ERTA	200[b]	15,160	30	30
ERTA[c]	0	15,310	18	18
§ 2214	90	15,220	18	13.5

[a]Assumed that $200/$400 exemption would have been extended.

[b]Cap on saving exemption reached.

[c]Indexing adjustment assumes 5% inflation and 1 exemption(s).

Assumed that amount of savings and income from other sources are constant.

Assumed that interest deductions are zero.

Table 3

Filing Status : Single

Taxable Income NOT from Interest or Dividends : $25,000

Amount of Savings : $20,000

Interest or Dividends : $2,400 (Interest Rate = 12 %)

Year	Savings Exemption	Total Taxable Income	Marginal Tax Bracket	Marginal Tax Rate on Savings
1982: Pre-ERTA[a]	200[b]	$27,200	39%	39%
ERTA	0	27,400	35	35
§ 2214	300	27,100	[illegible]	30.6
1983: Pre-ERTA	200[b]	27,200	39	39
ERTA	0	27,400	32	32
§ 2214	500[b]	26,900	32	32
1984: Pre-ERTA	200[b]	27,200	39	39
ERTA	0	27,400	30	30
§ 2214	500[b]	26,900	30	30
1985: Pre-ERTA	200[b]	27,200	39	39
ERTA[c]	360	26,990	30	25.5
§ 2214	500[b]	26,850	30	30

[a] Assumed that $200/$400 exemption would have been extended.

[b] Cap on saving exemption reached.

[c] Indexing adjustment assumes 5% inflation and 1 exemption(s).

Assumed that amount of savings and income from other sources are constant.

Assumed that interest deductions are zero.

Senator PACKWOOD. Mr. Raboy, I am curious about your tax neutrality theory. The Government tries to encourage a number of things beyond what the marketplace would encourage. Homeownership is one—the mortgage interest deduction.

Are you suggesting that instead of using the Tax Code, that is, the mortgage tax deduction, the Government wants to continue the policy beyond the marketplace, that we would in essence go to a HUD kind of program—if you want to buy a house, you apply to the Department of Housing and Urban Development; they give you a grant—that they do in essence the same thing the mortgage deduction does?

Mr. RABOY. Let me say this. I think, again as a general principle, the Tax Code ought not to be used to direct economic activity. But there are instances, again, where the market does fail. And if the Government, in its infinite wisdom, decides that such a market failure exists, then they do have the choice of going to a direct grants-in-aid program, as you suggest, or using the Tax Code.

Senator PACKWOOD. Or a tax incentive.

Mr. RABOY. But the relevant criteria there is, Which is the most efficient way to levy the subsidy?

Senator PACKWOOD. Well, I'm curious now. Can you think of any Government program that would be more effectively administered, assuming you are going beyond the marketplace, by the process of taxation, authorization, appropriation, the Government bureaucracy, allocation in grants, as opposed to a tax-incentive system?

Mr. RABOY. The one area that immediately comes to mind is possibly the area of industrial basic research and development, simply because the grant-in-aid program is so complex. You know, you have to go to the NSF for a grant, you have to go through a board of review, and that sort of thing.

Possibly, since R. & D. is so much related to uncertainty in the market, the best way to achieve that might be via the type of tax credit that we have in the code now.

Senator PACKWOOD. Let me give you another one. It has been the policy of this Congress, and so far of past administrations, to encourage the residential installation of alternative energy—wind, solar, geothermal. Now you can argue about the policy, but that is the policy.

If we wanted to achieve that, would we be better off to get rid of the 40-percent residential tax credits on solar energy and say to the Department of Energy, "Henceforth you will administer a program to try to achieve roughly the same result"?

Mr. RABOY. There was a recent paper that was published in the Journal of Political Economy by Prof. William Baumol. In that paper he argued that in fact the tax-related subsidy of that type of operation had created sufficient inefficiency that, net, there was an energy loss for the whole country. But, at any rate, what he is arguing is that you have to balance out the tax-induced distortions that this type of program might bring about and the benefits. I am just not sure that the benefits outweighed the costs in that one.

Senator PACKWOOD. Senator Danforth? Senator Schmitt?

Senator SCHMITT. Mr. Chairman, I appreciate this testimony. I understand some of the tradeoffs that were mentioned. We have gone through that, and I'm sure we will continue to go through it.

With the cooperation of this committee, I would ask that the statement by the Stockholders of America, Inc., be placed in the record with this panel.

Senator PACKWOOD. Without objection.

[The above statement follows:]

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

GENTLEMEN:

I APPRECIATE THE OPPORTUNITY TO SUBMIT THIS TESTIMONY IN SUPPORT OF THE SAVINGS & INVESTMENT INCENTIVES ACT OF 1982 (S.2214) ON BEHALF OF STOCKHOLDERS OF AMERICA, INC. I AM MARGARET COX SULLIVAN, PRESIDENT OF THIS NATIONAL, NON-PROFIT, NONPARTISAN, MEMBERSHIP ORGANIZATION ESTABLISHED IN 1972 TO REPRESENT THE INTERESTS OF ALL THE 32.6 MILLION STOCKHOLDERS WHO SHARE IN THE OWNERSHIP OF APPROXIMATELY 13,500 PUBLICLY HELD CORPORATIONS. OUR HEADQUARTERS ARE IN WASHINGTON, D.C. WE ARE NOT CONCERNED WITH WHAT STOCKS A MEMBER OWNS OR THE SIZE OF HIS/HER PORTFOLIO. STOCKHOLDERS OF AMERICA DOES NOT ENTER CLASS ACTION SUITS, PROXY FIGHTS OR THE INTERNAL AFFAIRS OF ANY COMPANY, NOR DO WE GIVE INVESTMENT ADVICE OR COUNSELING, BUT WE HAVE AN ABIDING CONCERN FOR THE TAX STRUCTURE, THE STRUCTURE OF THE MARKETS AND THE HEALTH OF OUR FREE-ENTERPRISE SYSTEM AND THE NATIONAL ECONOMY.

I BELIEVE IT WOULD BE SAFE TO SAY THAT IT IS THE ECONOMY THAT IS UPPERMOST IN THE MINDS OF MOST AMERICANS TODAY. HIGH INTEREST RATES, INFLATION AND UNEMPLOYMENT COME INTO EVERY CONVERSATION FROM THE GROCERY STORE TO THE BOARD ROOM.

INTEREST RATES, OF COURSE, ARE THE PRICE TAG PUT ON MONEY AND LIKE ANY OTHER COMMODITY, CONTROLLED BY THE FORCES OF SUPPLY AND DEMAND. THE FACTORS CONTROLLING THESE HIGH RATES ARE EXPECTED RATE OF INFLATION AND THE STRONG DEMAND FOR CREDIT BY GOVERNMENT, BUSINESS AND INDIVIDUALS WHO ARE COMPETING WITH ONE ANOTHER FOR THIS SUPPLY.

TO REMEDY THIS, THE NATIONAL POOL OF CAPITAL HAS TO BE INCREASED. THE SAVINGS & INVESTMENT INCENTIVES ACT OF 1982, INTRODUCED BY SENATOR SCHMITT (R.NM) FOR HIMSELF AND SENATORS PACKWOOD (R.OR), SYMMS (R.ID), GRASSLEY (R.ID), AND MATTINGLY (R.GA), IS DESIGNED TO DO JUST THAT. IT WOULD ENCOURAGE SAVINGS AND INVESTMENT AND DISCOURAGE CREDIT EXPANSION BY A CAREFULLY PHASED IN FORMULA.

IT IS A WELL-ESTABLISHED FACT THAT THE RATE OF PERSONAL SAVINGS IS LOW IN THE UNITED STATES. AS A MATTER OF RECORD, IT IS THE LOWEST OF ANY INDUSTRIALIZED NATION. JAPAN - OUR BIGGEST INDUSTRIAL COMPETITOR - HAS A HIGH OF 18%; THE U.S., A LOW OF 5%; WITH THE UNITED KINGDOM, GERMANY, FRANCE AND CANADA IN BETWEEN. PERHAPS, THE MOST IMPORTANT INDICATION OF THIS LOW 5% FIGURE IS THAT IT POINTS UP AN ATTITUDE IN BOTH OUR SOCIETY AND OUR GOVERNMENT - AN ATTITUDE WE HAVE DRIFTED INTO - THE BUY TODAY AND PAY TOMORROW MENTALITY. WHEN WE LOOK BACK IN THE HISTORY OF AMERICA, THIS TYPE OF THINKING IS THE VERY OPPOSITE OF THE KIND OF ATTITUDE WHICH BUILT THIS COUNTRY. PERSONAL SAVINGS WAS A WAY OF BUILDING A STAKE - A STAKE TO BE INVESTED AND EXPANDED IN OUR CAPITALISTIC SYSTEM, CALLED FREE-ENTERPRISE OR "PEOPLE'S CAPITALISM".

WE MUST NEVER FORGET THAT IT IS THIS SYSTEM THAT ALLOWED THE PEOPLE TO BUILD OUT OF A WILDERNESS THIS ONCE NUMBER ONE GREAT INDUSTRIALIZED NATION AND IT IS THE PEOPLE WHO CAN BUILD IT BACK TO THAT LEADERSHIP SPOT. GIVEN THE NEEDED WORKING CAPITAL, WE CAN REBUILD OUR GREAT ECONOMIC ENGINE AND EXPAND OUR ECONOMY AND THIS NECESSARY CAPITAL MUST BE ATTRACTED BACK INTO THE MARKET. THIS SUPPLY OF CAPITAL WILL COME FROM THE SAVERS AND INVESTORS. HISTORICALLY IT

ALWAYS HAS AND THAT IS WHY THE SAVINGS & INVESTMENT INCENTIVES ACT IS SUCH AN IMPORTANT PIECE OF LEGISLATION AT THIS TIME. IT WILL PROVIDE THE INCENTIVES THAT ENCOURAGE SAVINGS AND INVESTMENT. IT'S AS SIMPLE AS THAT.

WE HAD THE PROOF OF THIS IN THE LAST THREE YEARS - GIVEN THE INCENTIVES, REALLY LIFTING THE TAX BIAS AGAINST INVESTING, TENDS TO FREE THE CAPITAL TO BE PUT TO WORK. LET ME EXPLAIN. AFTER THE REVENUE ACT OF 1978 WAS ENACTED WHICH LOWERED THE TAX ON CAPITAL GAINS, 132,000 NEW INVESTORS ENTERED THE STOCK MARKET IN AN AVERAGE MONTH COMPARED TO THE PREVIOUS AVERAGE MONTH OF 87,000. NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS WAS $2.5 BILLION MORE FOR 1978-1979 THAN FOR 1976-1977. THIS AMOUNT OF MONEY HAS THE POTENTIAL TO CREATE 160,000 NEW JOBS. TREASURY REVENUE FROM CAPITAL GAINS INCREASED BY $1.8 BILLION FOR 1979.

IN A SURVEY JUST RELEASED BY THE NEW YORK STOCK EXCHANGE FOR THE 12-MONTH PERIOD JUNE 1980 TO JUNE 1981 - WHICH BROUGHT TO THE MARKET AN ADDITIONAL 2 MILLION NEW STOCKHOLDERS - CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS WAS $4.3 BILLION MORE IN 1981 THAN IN 1980. THIS AMOUNT OF MONEY HAS THE POTENTIAL TO CREATE MORE THAN 250,000 NEW JOBS. TREASURY REVENUE FROM CAPITAL GAINS INCREASED AN ESTIMATED $2 BILLION FOR 1981.

IT MUST NOT BE OVERLOOKED THAT THE FURTHER REDUCTION TO 20% ON CAPITAL GAINS TRANSACTIONS AFTER JUNE 9, 1981, AS COVERED IN THE '81 ECONOMIC RECOVERY ACT WAS NOT INCLUDED IN THE SURVEY. CERTAINLY THEN THE FURTHER LOWERING OF THE TAX ON CAPITAL GAINS WILL PROVE TO BE ANOTHER INCENTIVE

FOR STOCK INVESTMENT. THE ONLY REASON WE'RE BRINGING THIS INTO OUR TESTIMONY IS TO SHOW THAT INCENTIVES ATTRACT NEW INVESTMENT AND THIS INVESTMENT PUTS THE CAPITAL INTO THE MARKET AND THE CAPITAL SUPPLY RELATES DIRECTLY TO INCREASE IN TREASURY REVENUE AND CREATES MORE JOBS. THE SAVINGS & INVESTMENT INCENTIVES ACT ADDRESSES THE PROBLEM FROM A DIFFERENT DIRECTION. IT IS BECAUSE OF THE INCENTIVES FOR INVESTMENT IN THIS BILL THAT WE SUPPORT IT.

WE CANNOT STRESS ENOUGH THE PIVOTAL ROLE THAT EQUITY INVESTING PLAYS IN OUR NATIONAL PROSPERITY - OR THE IMPORTANCE OF THE INDIVIDUAL INVESTOR TO EQUITY INVESTING. AS A MATTER OF FACT WE HAVE BEEN STRESSING THIS THEME FOR 10-YEARS, AND I MIGHT ADD THAT AT TIMES WE THOUGHT WE WERE FIGHTING THIS BATTLE ALONE.

A CASE IN POINT: WHEN THE NEW YORK STOCK EXCHANGE RELEASED THEIR '75 SURVEY, IT REVEALED THE NUMBERS OF INDIVIDUAL STOCKHOLDERS HAD DECLINED BY 13%. WE POINTED OUT BEFORE THE TAX WRITING COMMITTEES OF BOTH BODIES OF CONGRESS, THAT THIS SHOULD BE VIEWED AS A NATIONAL EMERGENCY AND SHOULD BE CORRECTED WITH EMERGENCY INCENTIVE MEASURES. WE POINTED OUT THAT IT WAS THE FIRST TIME SINCE '52 THAT SUCH STATISTICS HAD BEEN RECORDED AND THAT THE NUMBER OF STOCKHOLDERS HAD NOT INCREASED. FURTHER, WE SAID THAT THIS WAS PARTICULARLY JOLTING ALONG SIDE ESTIMATES THAT IT WOULD BE MANDATORY, ACCORDING TO ESTIMATES, THAT THERE SHOULD BE AT LEAST 50 MILLION STOCKHOLDERS BY 1980 TO MEET THE EXPANDING CAPITAL NEEDS FOR THE GROWING WORK FORCE, TO KEEP OUR INDUSTRIAL LEADERSHIP IN THE WORLD, TO KEEP OUR COUNTRY STRONG AND TO MAINTAIN OUR STANDARD OF LIVING. I FURTHER POINTED OUT, THAT AT THE SAME PERIOD IN OUR NATIONAL HISTORY WHEN

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THE NUMBER OF STOCKHOLDERS WAS GROWING, WE AS A COUNTRY WERE ENJOYING RAPID, PROSPEROUS, ECONOMIC EXPANSION.

THIS WAS NOT DONE. BUT WHEN IT WAS DONE IN PART YEARS LATER, WITH THE REVENUE ACT OF 1978, STOCKHOLDERS CAME BACK IN THE MARKET. THIS IS A VERY IMPORTANT TREND AND SHOULD BE NURTURED AND ENCOURAGED. WE ARE PRESENTLY BACK TO ABOUT THE NUMBER BEFORE THE DECLINE.

THERE IS NOW A STOCKHOLDER IN ONE OUT OF EVERY FOUR HOUSEHOLDS IN THE UNITED STATES. THESE 32 MILLION PEOPLE ARE A DIVERSIFIED GROUP. THEY COME FROM EVERY WALK OF LIFE, IN EVERY PART OF THE COUNTRY. THEY ARE NOT THE SO-CALLED "RICH" - ACTUALLY THE AVERAGE PORTFOLIO IS ABOUT $5,000. THEY ARE BLUE COLLAR AND WHITE COLLAR WORKERS. THEY ARE TELEPHONE LINEMEN AND OPERATORS, SCHOOL TEACHERS, BARBERS, SHOPKEEPERS, SALESMEN, OFFICE WORKERS, CONSTRUCTION WORKERS, PILOTS, TRUCK DRIVERS, DOCTORS, LAWYERS, MILITARY PERSONNEL AND RETIRED PEOPLE; AND THE SUCCESS AND STRENGTH OF OUR SYSTEM HAS COME FROM THIS LARGE AND DIVERSIFIED GROUP.

STOCKHOLDERS HAVE BEEN CALLED THE HEART OF THE FREE-ENTERPRISE SYSTEM AND THEIR ROLE IS VITAL. ACTUALLY, THE CAPITAL MARKETS WON'T WORK WITHOUT THEM. THEY MAKE THE MARKET. THE MILLIONS OF DIVERSIFIED MARKET TRANSACTIONS ARE NEEDED DAILY FOR LIQUIDITY, FOR A TRUE AUCTION, AND A MORE REALISTIC VALUE OF STOCKS. FURTHER, THE INDIVIDUAL HAS A DIFFERENT PATTERN OF INVESTING THAN THE LARGE FINANCIAL INSTITUTIONS. FUND MANAGERS, EITHER BECAUSE OF REGULATIONS OR FIDUCIARY RESPONSIBILITIES, INVEST PRIMARILY IN THE WELL-ESTABLISHED COMPANIES AND FOR THE MOST PART IN A FAVORED FEW. THE INDIVIDUAL, IN HIS OWN FRAME OF INTEREST, AND JUDGEMENT, WITH HIS OWN CAPITAL

MAY MAKE INVESTMENTS IN THE SMALLER, OFTEN MORE VENTURESOME - HIGH RISK COMPANIES - SOMETIMES REGIONAL ONES WHERE NEW JOBS ARE CREATED.

THIS INCENTIVES ACT IS DESIGNED TO ATTRACT THESE PEOPLE AND GIVE THEM ENCOURAGEMENT TO SAVE AND INVEST MORE OF THEIR CAPITAL, INCREASING THEIR STAKE IN THE COMPANY OF THEIR CHOICE OR INVESTING IN NEW COMPANIES. THE SAVINGS & INVESTMENT INCENTIVES ACT WOULD DO THIS FOR IT WOULD:

--EXEMPT FROM TAXES 25% OF DIVIDEND INCOME
--EXEMPT 25% FROM TAX ON NET INTEREST INCOME
--CAP THE MAXIMUM EXEMPTION AT $500 FOR AN INDIVIDUAL RETURN AND $1000 FOR A JOINT RETURN
--PHASE OUT AT 25% A YEAR THE DEDUCTION OF CONSUMER INTEREST EXPENSE BEGINNING JULY 1, 1982; 50% IN '83; 75% IN '84; AND 100% IN '85 AND BEYOND. HOME MORTGAGE EXPENSE, TRADE OR BUSINESS INTEREST EXPENSE, INVESTMENT INTEREST EXPENSE, AND INTEREST EXPENSE RESULTING FROM AN AUTOMOBILE OR EDUCATION LOAN WOULD BE UNAFFECTED BY THIS LEGISLATION AND WOULD REMAIN FULLY DEDUCTIBLE
--BE EFFECTIVE AS OF JULY 1, 1982

THE REVENUE IMPACT OF THIS LEGISLATION WILL GENERATE REVENUES TO THE TREASURY IN THE AMOUNT OF $2.3 BILLION.

SENATOR SCHMITT, IN INTRODUCING THIS BILL SAID, "IT IS CLEAR THAT IN THE PAST THE UNITED STATES HAS UNINTENTIONALLY CREATED A TAX SYSTEM THAT IS HEAVILY WEIGHTED IN FAVOR OF DEBT AND CONSUMPTION, AND AGAINST SAVINGS AND INVESTMENT. THIS BILL IS INTENDED AS A COMPLEMENT TO STEPS ALREADY MADE TO REVERSE THE WEIGHTED SCALES, AND IS DESIGNED TO INSURE THAT THE HOPED FOR INCREASES IN SAVINGS AND INVESTMENT THAT OUR ECONOMY MUST HAVE IF IT IS TO GROW, WILL IN FACT OCCUR."

IN OUR OPINION IT WILL.

AGAIN, THANK YOU.

Senator SCHMITT. I think it is important to emphasize again that the impact of the current code as it relates to deductions of consumer interest is regressive.

I have illustrated this point in a table which was included in previous testimony and therefore part of the record. It is table No. III, Number of Returns and Total Estimated Non-Mortgage Interest Deductions, 1980. Although the numbers of the returns of course are very high in the lower income area, the table shows that the nonmortgage interest deductions are relatively small; and certainly the average deduction per return is very small. In the order of the lowest income brackets, the average is a little over $6.

Therefore, I believe that we are not only finding a way to help pay for the static costs—and I emphasize and underline "static costs"—of an interest exclusion, but also addressing what has had a regressive impact on lower income taxpayers.

Thank you.

Senator PACKWOOD. Thank you.

Gentlemen, thank you very much. Next we will have a panel consisting of Dr. Thomas Durkin and Mr. Ray Kennedy.

Do you want to go first, Dr. Durkin?

STATEMENT OF THOMAS DURKIN, PH. D., DIRECTOR OF RESEARCH, NATIONAL CONSUMER FINANCE ASSOCIATION, WASHINGTON, D.C.

Dr. DURKIN. Thank you, Mr. Chairman.

My name is Tom Durkin. I am director of research and education of the National Consumer Finance Association and adjunct senior research associate in finance at the Pennsylvania State University.

We welcome this opportunity to comment today on NCFA's views concerning S. 2214.

NCFA shares the committee's concerns about the implications for national savings and investment of the large and projected persistent deficits in the fiscal accounts of the United States. We question, however, whether S. 2214, either alone or in conjunction with other limited measures, is the proper way to address such fundamental questions of national concern.

Large Federal deficits suggest that we have been unable or unwilling as a nation to pay currently for the goods, services, and transfer payments we have requested government to provide. Doing nothing about this, by implication causing the Treasury to finance the deficit by borrowing, presents severe economic and financial disadvantages. Notably, it preempts the savings necessary to modernize industry and encourage long-term real income growth while keeping real interest rates too high.

If do in nothing is unattractive and resorting to inflationary money creation to finance the deficitis ruled out, as seems proper, then only two options remain: raising taxes or cutting expenditures.

S. 2214 addresses one of these—raising taxes—by eliminating deductibility of consumer credit interest charges. Although the bill also contains other provisions designed to encourage savings, NCFA believes that both portions of S. 2214—raising taxes and encouraging savings—should only be considered within a broader framework for rationalizing the already far too complex Federal tax system. At a time when the Federal budget is in structural disequilibrium, something more fundamental than another group of complex selective ad hoc changes is needed.

One approach that has much to recommend it is the flat-rate income tax approach introduced in S. 2147 by Senator DeConcini. This approach to Federal revenue raising would involve applying a flat percentage tax rate to all forms of personal and corporate income.

In an interesting article in the Wall Street Journal, Monday this week, Paul Craig Roberts, formerly Assistant Secretary of the Treasury for Economic Policy, suggested that a 16-percent flat tax rate on personal and corporate income would balance the 1983 budget. Imagine, according to Mr. Roberts, the attractiveness of an economy operating with a balanced budget and a top marginal tax rate of 16 percent, but free of bracket creep, tax indexing, high interest rates, crowding out, marriage penalties, and penalties for success.

If the Congress believes that lower income Americans should pay less on a percentage basis, then some initial amount of income could be exempted from tax.

However, instead of adopting this attractive approach, S. 2214 does nothing to alleviate the marginal tax rates that are still far too high while it eliminates deductions on a selective, limited basis.

S. 2214 also raises a number of more specific questions. First, if exclusion of a portion of net interest income is in the public interest, then why is not exclusion of all such net interest income in the public interest? Conversely, if taxation of a part of such income is in the public interest, why is not taxation of all such net interest income in the public interest? It seems that the flat-rate proposal answers this question more consistently. It taxes all interest income to raise the needed revenues, but the marginal tax rates would not be so high as to discourage financial investments.

Second, why should finance charges on credit for automobiles continue to be deductible for tax purposes but not interest on credit for other important purposes like medical credit and student loans? Certainly NCFA agrees that encouraging automobile sales is a worthwhile goal for Congress to consider. But does Congress want to make medical and educational services more expensive for the middle class as this bill would do?

Third, why does this legislation assume that consumer borrowing is bad and should be discouraged at all? Consumers borrow not for consumption but rather for investment in consumer capital goods and services like homes, automobiles, appliances, education, and other services. Consumer capital is exactly analogous to business capital like factories, machines, and equipment which provide returns to business. Investing in capital goods, consumers, like business, can raise the total returns available to them over time. Does Congress really want to reduce borrowing for such productive purposes?

Fourth, how much revenue will actually be raised by this measure at the cost of increasing the complexity and the perceived unfairness of our tax system?

Fifth, if automobile, home mortgage, investment, and possibly some other forms of credit are to be exempted, will not this require another quantum jump in the complexity of figuring and filing personal taxes?

Sixth, and last, will not the approach of selectively raising real costs for certain kinds of consumer credit unfairly affect certain innocent industries such as, for example, the boat, furniture, and appliance industries considerably more than others? S. 2214 appears to intend selectivity, but is selective devastation of industries good public policy when the real need is to balance the federal budget?

Senator DANFORTH. Mr. Kennedy?

STATEMENT OF RAY KENNEDY, VICE PRESIDENT FOR CREDIT, SEARS, ROEBUCK & CO., CHICAGO, ILL., ON BEHALF OF AMERICAN RETAIL FEDERATION AND NATIONAL RETAIL MERCHANTS ASSOCIATION, WASHINGTON, D.C.

Mr. KENNEDY. Thank you, Mr. Chairman.

I am Raymond Kennedy, vice president and general credit manager of Sears merchandise group. Accompanying me today is Cliff Massa, attorney with the Patton, Boggs, & Blow firm. We are appearing on behalf of the National Retail Merchants Association and the American Retail Federation to present our views regarding S. 2214, the Savings and Investment Incentives Act introduced on March 16 by Senator Schmitt.

Section II of S. 2214 would eliminate the income tax deduction for interest paid on most consumer debt. The general merchandise retail industry opposes section II of S. 2214 for three reasons.

First, there is no evidence that consumer demand for credit is excessive or that it has contributed to high interest rates.

Second, by discouraging consumer spending, section II may prove counterproductive to the goals of economic recovery.

Third, the bill unfairly and capriciously discriminates between certain types of consumer debt, allowing the interest deduction for certain purchases while denying it for others.

In his introductory remarks of March 16, 1982, Senator Schmitt states that section II is designed to reduce the exploding consumer demand for credit which, in his view, has fanned the flames of inflation and pushed interest rates to alltime highs.

Now, this argument is erroneous. There is no evidence that consumers have been unduly speculative or have used credit unwisely in recent years. There has been no growth in total net credit extensions over liquidations between the peak of June 1978 and February of this year. In December 1979 total installment credit outstanding peaked at 18.1 percent of disposable income. In February of this year the figure was 15.5 percent of disposable income, a drop of 2.6 percentage points over the last 3 years.

Section II of S. 2214 is clearly designed to reduce consumer use of credit. A secondary effect of this provision, especially for those taxpayers least able to afford cash payments for large consumer goods, will be an overall reduction in consumer spending.

As retailers learned during the Carter administration's unsuccessful attempt to control inflation by controlling credit, credit allocation measures such as the one envisioned by S. 2214 will produce severe marketplace dislocations.

In 1980 credit controls had a severe adverse impact on total sales which continued for many months, even after the allocation measures were lifted. The sales impact was much larger than expected due to the psychological factors which led customers to limit both necessary as well as discretionary purchases. This would surely happen again if S. 2214 were enacted.

Retailing strongly believes that such a reduction in consumer spending at this time would endanger efforts to revive the U.S. economy. Increased consumer spending is essential to swift economic recovery.

In introducing the bill, Senator Schmitt claimed that an additional benefit of eliminating the itemized deduction of interest expenses is that it will also eliminate discrimination in the Tax Code between certain types of taxpayers—those who itemize, and those who do not.

However, section II, by making exceptions for interest expenses incurred when purchasing a home, a car, a college education, not only perpetuates discrimination between taxpayers but actually worsens it.

Why should the manufacturer, retailer, and purchaser of an automobile be treated more favorably by the Tax Code than the manufacturers, retailers, and purchasers of other large and expensive goods such as home appliances, boats, or other recreational vehicles? Why should the individual who may be able to afford a house be eligible for an interest deduction while another individual cannot deduct the interest incurred when purchasing home furnishings?

Any limitation on deductions for certain types of interest will lead to unequal treatment of just the kind that S. 2214 purports to correct. The bill will hurt those taxpayers who will least afford it.

Many taxpayers will have the flexibility to avoid the limitations of the Schmitt bill simply by reducing their use of consumer credit and increasing their borrowings for investment, housing, autos, or higher education. Other taxpayers may not be so fortunate.

Thank you, Mr. Chairman.

[The prepared statements of the previous panel follow:]

STATEMENT OF THOMAS A. DURKIN, DIRECTOR OF RESEARCH AND EDUCATION, NATIONAL CONSUMER FINANCE ASSOCIATION

My name is Thomas A. Durkin. I am Director of Research and Education of the National Consumer Finance Association (NCFA)[1/] and Adjunct Senior Research Associate in Finance at the Pennsylvania State University. We welcome this opportunity to comment today on NCFA's views concerning S2214, a bill to amend the Internal Revenue Code of 1954 to provide a partial exclusion for dividends and interest received and to eliminate the deduction for consumer interest paid or accrued.

NCFA shares the Committees' concerns - and, I think, the concerns of all Americans - about the implications for national savings and investment of the large and projected persistent deficits in the fiscal accounts of the United States. We question, however, whether S2214, either alone or in conjunction with other limited measures, is the proper way to address such fundamental questions of national concern.

1/ Organized in 1916, NCFA is the national trade association of companies engaged in the consumer credit business. NCFA represents over 700 companies operating more than 15,000 offices serving the public throughout the country. The membership of NCFA is highly diversified ranging from single, small loan offices to substantial nationwide financial services organizations engaged in unsecured direct lending, second mortgage lending and the financing of the sale of durable goods. The consumer finance industry accounts for approximately one-fourth of all consumer credit outstanding, or approximately $90 billion of the $327 plus billion outstanding.

Large Federal deficits suggest that we have been unable or unwilling as a nation to pay currently for the goods, services, and transfer payments we have requested government to provide. This is, of course, not a new problem - it existed in the Continental Congress and at other times in our national history, most importantly during extreme national emergencies such as the Revolutionary War, the War Between the States, and World War II. Earlier, as now, Congress could have chosen from among three courses of action (or combinations): it could have raised taxes, appropriating more of national income to the government; it could have cut spending or transfer payments with possible military consequences in wartime or social consequences during peace; or it could have printed the necessary currency to close the deficit with attendant inflationary impact. Each of these alternatives has been tried, each with its own immediate social advantages but also with long-term drawbacks. The only alternative has been, and is, to do nothing, by implication causing the Treasury to finance the deficit by borrowing. Unfortunately this approach also presents economic and financial pitfalls. Notably, it preempts the saving necessary to modernize industry and encourage long-term real income growth while keeping real interest rates too high.

Current evidence indicates that doing nothing is not an attractive alternative. A recent analysis of the Federal budget situation by the Conference Board, a private economic research organization, shows that for the first time in the postwar period the Federal budget is in structural disequilibrium. According to Michael E. Levy of The Conference Board, this means that an extension of the current budget program without future legislative changes or adjustments would generate steadily increasing Federal budget deficits. In contrast, past budget programs when extrapolated this way produced first declining deficits and then surpluses in outlying years as income growth produced additional tax revenues faster than the baseline budget mandated more spending. This demonstrates the severity of our current problem: not only is the Federal government preempting from industry a huge number of available dollars in our capital markets, but it is likely under current plans to continue to do so for many years to come.

If doing nothing is unattractive this leaves raising taxes, cutting spending, and employing the printing press as the options. If resort to inflationary money creation is ruled out, as seems proper, then only two options remain, raising taxes or cutting expenditures. S2214 addresses one of these - raising taxes - by eliminating deductibility of consumer credit interest charges. Although the bill also contains other provisions designed to encourage savings by excluding a portion of interest and dividends from Federal income taxation, NCFA believes that both portions of S2214 - raising taxes and encouraging savings - should only be considered within broader framework for rationalizing the already far too-complex Federal tax system.

Less than a year ago Congress indicated its belief in the economic efficacy of tax cuts in improving economic productivity and performance when it passed the Economic Recovery Tax Act of 1981. Apparently a majority of Congress believed that inflation, combined with ever higher marginal tax rates were stifling productivity and real economic growth. The questions in 1982 is why is this situation any different than in 1981? If high and rising marginal tax rates were stifling in 1981, why are higher tax rates a good idea this year? At a time when the Federal budget is in structural disequilibrium, something more fundamental than another group of complex, selective, ad hoc changes are needed. One approach that has much to recommend it is the Flat-Rate Income Tax approach introduced in S2147 by Senator DeConcini. This approach to Federal revenue raising would involve applying a flat precentage tax rate to all forms of personal and business income. It would reform what Senator DeConcini characterized as "a labyrinth for the wary and unwary alike, filling endless volumes with its exceptions to exceptions and indecipherable differentiations in the way we tax various sources of income."

The flat-rate tax is, of course, not a new idea, but it is one that should be examined closely. The public is disgruntled with constant tax tinkering and the judgments such ad hoc adjustments require. Today not only does the Federal tax system fail to produce the revenues to support the spending levels Congress apparently believes are needed, but it is also perceived as grossly unfair. Virtually everyone can cite special tax provisions that are useful to others, but which are believed to be unavailable to himself or herself. Many, perhaps all, of these special provisions are in the public interest defined in some way. The problem is that everyone sees the public interest differently and the perceptions are that the tax system is designed to appease "special interests" rather than support the "public interest." Very simply, the problem with S2214 is that it will do little to solve the budget deficit problem, but it will strike millions of middle class Americans as another unfair tax change affecting them more severely than others.

Tuesday of this week Paul Craig Roberts, formerly Assistant Secretary of the Treasury for Economic Policy, in an interesting article in the Wall Street Journal suggested that a 16 percent flat tax rate on personal and corporate income would balance the 1983 budget. Imagine, according to Mr. Roberts, the attractiveness of an economy operating with a balanced budget and a top marginal tax rate of 16 percent but free of bracket creep, tax indexing, high interest rates, crowding out, marriage penalties, and penalties for success. Imagine, too, ending the general current perception that the tax system favors someone else. If Congress believes that lower-income Americans should pay less on a percentage basis, then some level of personal exemptions could be legislated or some initial amount of income could be exempted from tax. However, instead of adopting this attractive approach S2214 does nothing to alleviate marginal tax rates that are still far too high while it eliminates deductions on a selective, limited basis.

Specific provisions of S2214 also raise a number of important questions. First, if exclusion of a portion of "net interest income" (defined as interest and dividend income earned by a taxpayer in a given year minus any interest payments on consumer credit exclusive of residential mortgage and investments credit) is in the public interest, then why is not exclusion of all such net interest income in the public interest? Conversely, if taxation of part of such income is in the public interest, why is not taxation of all such net interest income in the public interest? It seems that the flat-rate proposal answers this question more consistently: it taxes all interest income to raise needed revenues, but the marginal tax rates would not be so high as to discourage financial investments.

Second, why should finance charges on credit for automobiles continue to be deductible for tax purposes, but not interest on credit for other important purposes like medical credit and student loans? Certainly NCFA agrees that encouraging automobile sales is a worthwhile goal for Congress to consider. But does Congress want to make medical and educational services more expensive for the middle class as this bill would do? Congress might also ponder this question.

Third, why does this legislation assume that consumer borrowing is bad and should be discouraged at all? The statement in the Congressional Record accompanying introduction of this bill argues that "elimination of this incentive to borrow is essential in light of the present credit explosion we have seen occur inthe recent past." Unfortunately, this statement makes two mistakes: It misunderstands the reasons why consumers borrow, and it greatly exaggerates the extent of recent consumer borrowing.

The real reason for consumer borrowing is not consumption but rather investments in consumer capital goods and services like homes, automobiles, appliances, education, and medical services. Each of these capital goods and services provides a flow of returns over time in the form of valuable consumer services. None of these streams of returns is consumed immediately-here today and gone tomorrow. In this sense consumer capital is exactly analogous to business capital like factories, machines, and equipment which provide investment returns over time to business. By investing in capital goods consumers - like businesses - can raise the total returns available to them over time. Does Congress really want to reduce such borrowing for productive purposes.

As to growth, it simply is not the case that the increase in consumer credit recently has been "explosive." Consumer installment growth over the past two years grew at a compound rate of only 3 percent; excluding automobile credit the growth rate was below 3 percent. In deflated dollars consumer credit growth has been negative. Consumers' installment credit debt burden is lower as well; the ratio of installment credit debt repayments to disposable personal income peaked in 1978 and has been declining ever since. These facts, readily available from Federal agency data, contradict the view that consumer credit growth has recently been explosive. This is in sharp contrast to the Federal debt picture. Gross public debt of the Treasury and the Federal and Federally-sponsored credit agencies exceeded $1200 billion at year end 1981 and had grown 25 percent in the prior two years.

Fourth, how much revenue will actually be raised by this measure at the cost of increasing the complexity and the perceived unfairness of our tax system? It seems that after various exclusions that might be enacted (automobile credit alone accounts for almost 40 percent of consumer installment credit outstanding), the likely revenue gains would be small. However, the impact on selected consumers could be substantial as they see their real credit costs rise.

Fifth, if automobile, home mortgage, investment, and possibly some other forms of credit are to be exempted, will not this require another quantum jump in the complexity of figuring and filing personal taxes? Is this appropriate at a time when the President and many members of Congress have promised reductions in governmental complexity, bureaucratic rules, and governmental intrusion into the lives of citizens?

Sixth, will not the approach of selectively raising real costs for certain kinds of consumer credit unfairly affect certain innocent industries - such as, for example, the boat, furniture and appliance industries - considerably more than others? S2214 appears to intend selectivity but is selective devastation of industries good public policy when the real need is to balance the Federal budget?

In sum, NCFA strongly supports the goals of encouraging savings and investment while balancing the Federal budget. However, the Association believes that if new taxes are required to meet these objectives, t[illegible] a more comprehensive approach than another collection of ad hoc changes is needed. In this context the flat-rate tax proposal of Senator DeConcini has much to recommend it, including the prospect of a balanced budget with low marginal tax rates and elimination of the historical collection of special exceptions that have led to so many current distortions.

Statement of Raymond A. Kennedy on Behalf of the National Retail Merchants Association and the American Retail Federation

My name is Raymond A. Kennedy, Vice President and General Credit Manager for Sears, Roebuck and Company. I am appearing here today on behalf of the the National Retail Merchants Association (NRMA) and American Retail Federation (ARF) to present our views regarding S. 2214, The Savings and Investment Incentives Act, introduced on March 16, 1982, by Senator Schmitt.

By way of background, NRMA is the nation's largest trade association for the general merchandise retail industry. Its corporate members operate 40,000 department, chain and specialty stores across the country, with annual sales of approximately $175 billion, and nearly 3 million employees.

The ARF membership consists of 33 national retail trade associations, 50 state retail associations, the Greater Washington Board of Trade, as well as corporate members. Through its members, ARF represents more than a million retail establishments.

Like most U.S. industries, general merchandise retailers have been plagued by high interest rates and scarce capital. For this reason, retailing has been generally supportive of governmental efforts to boost economic growth, increase the amount of available capital, and bring down inflation rates.

Section 1 of S. 2214, The Savings and Investment Incentives Act, addresses this need for increased capital supplies by providing incentives for private savings. Retailing has no objections to these provisions.

However, Section 2 of S. 2214 would eliminate the income tax deduction for interest paid on most consumer debt. In his introductory remarks on S. 2214, Senator Schmitt indicates that this provision has been included in the bill to "reduce exploding consumer demand for credit" which, in his view, has led to high interest rates.

The general merchandise retail industry opposes Section 2 of S. 2214 for three reasons. First, there is no evidence that consumer demand for credit is excessive, or that it has contributed to high interest rates. Second, by discouraging consumer spending, Section 2 of S. 2214 may prove counterproductive to the goals of economic recovery. Third, the bill unfairly and capriciously discriminates between certain types of consumer debt, allowing the interest deduction for certain purchases while denying it for others.

S. 2214 Incorrectly Singles Out Consumer Credit as a Cause of Inflation and High Interest Rates

In his introductory remarks of March 16, 1982, Senator Schmitt states that Section 2 of S. 2214 is designed to reduce "the exploding consumer demand for credit" which, in his view, has "fanned the flames of inflation," and "pushed interest rates to all time highs."

This argument is erroneous. No long term evidence has ever been presented which shows that consumers have been unduly speculative, or have used credit unwisely in recent years. In fact, the more speculative users of credit have been staying away from risky investments because of high interest rates.

Recent indicators prove this conclusively. The Federal Reserve Board's seasonably adjusted figures show that there has been no growth in total net credit extensions over liquidations between the peak of June 1978 and February of this year. What's more, in December 1979, total installment credit outstanding peaked at 18.1 percent of disposable income. In February of this year, the figure was 15.5 percent of disposable income — a drop of 2.6 percentage points over the last 3 years.

S. 2214 May be Counterproductive to Efforts to Revive the Economy

Section 2 of S. 2214 is clearly designed to reduce consumer use of credit. A secondary effect of this provision, especially for those taxpayers least able to afford cash payments for large consumer goods, will be an overall reduction in consumer spending.

As retailers learned during the Carter Administration's unsuccessful attempt to control inflation by controlling credit, credit allocation measures such as the one envisioned by S. 2214 will produce severe marketplace dislocations. In 1980, credit controls had a severe, adverse impact on total retail sales which continued for many months, even after the allocation measures were lifted. Moreover, the sales impact was much larger than expected due to psychological factors which led consumers to limit both necessary as well as discretionary purchases. This would surely happen again if S. 2214 were enacted.

Retailing strongly believes that such a reduction in consumer spending at this time would endanger efforts to revive the U.S. economy. Increased consumer spending is essential to swift economic recovery. In the first quarter of recovery of the last two recessions (in 1974-75, and 1980) real Gross National Product rose at an average annual rate of 3.6 percent. Real consumer spending rose at an average annual rate of 5.7 percent. All other economic activity was flat in real terms with nonresidential capital spending still falling at an average annual rate of 5.4 percent. Vigorous growth in capital spending typically follows the recovery initiated by consumers by 9 to 12 months.

S. 2214 Unfairly Discriminates Between Certain Types of Consumer Credit

Section 2 of S. 2214 would deny the income tax deduction for interest paid on most consumer debt except interest incurred for (1) acquiring, constructing or rehabilitating structures used as dwellings, (2) the purchase of automobiles, or (3) higher education expenses. The bill does not exempt interest incurred to purchase food or clothing or any of the thousands of other products purchased by consumers.

In his introductory remarks of March 16, 1982, Senator Schmitt claims that an additional benefit of eliminating the itemized deduction of interest expenses is that it will also eliminate discrimination in the Tax Code between certain types of taxpayers— those who itemize, and those who do not.

However, Section 2 of S. 2214, by making exceptions for interest expenses incurred when purchasing a house, a car or a college education, not only perpetuates discrimination between taxpayers but actually worsens it.

Why should the manufacturer, retailer and purchaser of an automobile be treated more favorably by the Tax Code than the manufacturers, retailers and purchasers of other large and expensive goods such as home appliances, boats, or other recreational vehicles? Why should the individual who may be able to afford a house be eligible for an interest deduction, while another individual cannot deduct the interest incurred when purchasing home furnishings?

Section 2 of S. 2144 creates serious and capricious anomalies. For example, the purchaser of a new home, which includes all new home appliances would be able to deduct the interest on the purchase of those appliances. But the taxpayer who purchases an older home in need of new appliances will not receive the same tax treatment if that taxpayer chooses to buy appliances on a store charge account. The taxpayer who purchases home improvement items from the local hardware store, may be similarly excluded.

Moreover, any limitation on deductions for certain types of interest will lead to unequal treatment of just the kind that S. 2214 purports to correct. The bill will hurt most those taxpayers who can least afford it. Many taxpayers will have the flexibility to avoid the limitations of the Schmitt bill simply by reducing their use of consumer credit and increasing their borrowings for investment, housing, autos, or higher education. Other taxpayers may not be so fortunate. Money is largely fungible, and the Internal Revenue Code has wisely refrained to date from making numerous fine distinctions between types of interest payments.

<u>Summary</u>

NRMA and ARF believe that Section 2 of S. 2214 is ill-conceived. It unjustifiably discriminates between certain types of taxpayers in the name of eliminating discrimination in the Tax Code. It incorrectly lays the blame on credit expansion for pushing up interest rates. Finally, it ignores the important role that consumer spending must play in national economic recovery.

For these reasons, NRMA and ARF strongly urge the Subcommittees to reject the elimination of the income tax deduction for consumer interest expenses.

Senator SCHMITT. Mr. Kennedy, isn't it true that in the last several decades the ratio of outstanding installment credit to consumer liquid assets has been roughly constant, fluctuating some as interest rates in the recessionary period have risen?

Mr. KENNEDY. Yes, I think so.

Senator SCHMITT. They have been relatively constant?

Mr. KENNEDY. Yes, sir.

Senator SCHMITT. What evidence do you have that the phaseout of the consumer interest deduction would in fact cause a significant reduction in installment credit?

Mr. KENNEDY. I would say, principally my 34 years of experience in Sears credit operations.

Senator SCHMITT. But interest rates during that period of time have doubled and tripled—and in some cases without anything obvious except an increase in consumer credit. Why would the removal of this particular deduction have a greater effect, and in the opposite direction?

Mr. KENNEDY. Why was there such an effect from the credit restraint efforts of 1980? Actually that had a very small real effect on consumers, and yet it caused a tremendous reaction, and our business collapsed.

Senator SCHMITT. Well, there was a tremendous amount of publicity associated with it. There was a great psychological reaction. As a matter of fact, it reached the highest point in outstanding consumer installment credit since 1960.

Mr. KENNEDY. Yes.

Senator SCHMITT. And I don't think it is at all surprising considering the circumstances surrounding the imposition of credit controls—by the way, I opposed. But, nevertheless, I don't think it was suprising at all that you suddenly had a capping. It didn't drop off, it just stopped; and it stopped at a very high level.

Mr. KENNEDY. Well, our percentage at Sears dropped substantially, and we are not back to the percentage that we held at the time of that occurrence yet.

Senator SCHMITT. Well, I wouldn't expect you to be back there since history reveals that we have had a dropoff in outstanding installment credit in every recessionary period since 1960—I believe that this trend is due to a normal reaction—a psychological reaction—to a recessionary period and the concern over the continuation of income.

Mr. KENNEDY. Well, I am not sure that we were in a recession in March and April of 1980.

Senator SCHMITT. Well, I'll tell you, if you look at other economic indicators you will find that the recessionary trend, which hopefully has ended, began back in that period of time. Unemployment was going up, and there were a lot of other factors.

Mr. KENNEDY. Perhaps it hadn't been declared yet at that time. But let me approach it in another way. I think the bill gives recognition to the potential impact by exempting those industries that are in big trouble—the automobile industry and housing. We don't want to risk an additional impact on those industries. But ask the furniture and appliance manufacturers and dealers how they are doing right now, and they as well as retailers deserve the same concern. And for the same reasons that autos and housing won't be hurt by this bill, many other manufacturers and retailers will be hurt. And many businesses in these fields are in no better position to weather another setback like this than the auto or housing industry.

Senator SCHMITT. In terms of magnitude, individuals owe a much higher amount of interest in the auto and housing area than what we are talking about here with respect to consumer credit.

Mr. KENNEDY. Granted.

Senator SCHMITT. I think you also have to admit that the majority of those who shop at Sears do not itemize their deductions and so do not benefit.

Mr. KENNEDY. Well, I am not sure about that. I have seen some numbers, and I have seen 25 percent and 30 percent here today. But let me say that if a 30 percent or 25 percent, or 17 percent—which was the figure I read a few days ago—of our customers are influenced in their shopping because of this action, that is a devastating effect on the retailing industry. A 1- or 2-percent change in the amount of increase or the amount of decrease in sales can easily be the difference between a profitable business and a loss business in retailing.

Senator SCHMITT. But I hope that you will supply the committee with some evidence that this kind of change competes in its magnitude with rises in interest rates, during recessionary and other periods. I just don't think you have the evidence to demonstrate that, and I think that we have the evidence on the other side.

I certainly don't want to do what you are saying. If I thought the bill did, we never would have proposed it. But we researched it, we looked for evidence that there would be a dropoff in consumer spending and credit as a consequence of this action, and we found absolutely no evidence that there would be.

Mr. KENNEDY. Well, our customers want to buy on credit. And when something happens such as happened last year, they don't just stop buying on credit, they stop buying. I am not sure that this will be of the same scope as the credit restraint; but, even if it were half that much impact, or even a quarter of that much impact, it would have a very severe effect on retailing.

Senator DANFORTH. Gentlemen, thank you very much for your testimony.

The next panel consists of Mr. Robert Georgeson, Mr. Herbert Gray, and Mr. Joseph Cugini.

Please proceed, Mr. Georgeson.

STATEMENT OF ROBERT K. GEORGESON, EXECUTIVE VICE PRESIDENT, FIRST NATIONAL BANK, LAWRENCE, KANS., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, WASHINGTON, D.C.

Mr. GEORGESON. Thank you, Mr. Chairman and members of the subcommittees. My name is Robert K. Georgeson, and I am executive vice president of the First National Bank of Lawrence in Lawrence, Kans. I am testifying today in my capacity as chairman of the Installment Lending Division of the American Bankers Association, which association's membership consists of more than 90 percent of the Nation's full-service banks including more than 12,000 community banks with deposits of $100 million or less. We appreciate this opportunity to present our views on S. 2214, the Savings and Investment Incentives Act.

As a general policy, our association supports legislative initiatives to provide savings incentives. Indeed, we applaud the savings and incentives contained in section I of this legislation.

We have, in both testimony before Congress and in correspondence to members of the Administration, advocated changes in the Tax Code which would provide additional impetus for savings. It is critical to note, however, that our support for tax incentives for savings is conditioned on balancing any reduction in revenue that they cause. This should be accomplished generally with matching revenues from other changes in the tax laws or reductions in Government expenditures to prevent enlargement of the Federal deficit.

Additionally, in these times of projected $100-plus billion Federal deficits, deficit reduction measures should be primarily in the form of expenditure reductions.

The approach to offsetting losses in revenue due to the savings incentives contained in S. 2214 is not the correct approach. Phasing out the deductibility of consumer interest expense for certain categories of borrowing favors selected industries and discriminates against others. We cannot support this form of credit allocation. The approach effectively increases the cost of credit for some purposes while favoring others.

In an effort to avoid additional troubles for the ailing automobile and housing industries, it penalizes other business sectors such as durable goods, home furnishings, and the like, which are also vital to the recovery of our economy.

The stated target of this legislation is mainly credit cards and revolving-type interest. A recent study by the Credit Research Center of the Krannert Graduate School of Management at Purdue University indicates that the cost of the proposed change in the Tax Code would be borne by that segment of the population least able to avoid its impact: the low- and the middle-income taxpayer. A copy of the pertinent section of this study is attached to the written statement that we submitted.

The picture that emerges from the study is that the credit user is a low to middle income bracket individual with a family who is using the credit feature of the card to maintain his family's standard of living and make major purchases for which it finds it difficult to save in advance. It therefore appears that this credit user will bear the cost of the proposed elimination of the interest deduction. It supports the contention of many bankers that phasing out consumer interest tax deductions will not be effective in reducing borrowing levels. Rather, it will make the cost of borrowing higher for those who can least afford it.

The bill would thus increase the effective cost of credit for millions of taxpayers who earn less than $25,000 a year and utilize this type of credit to maintain their standard of living.

The impact of this bill, however, is not confined to just credit cards and revolving credit, it also targets many additional forms of credit. Revolving and credit card borrowing constitute only about one-half of consumer credit outstanding after the deduction of the five credit categories that are exempted in the bill.

Direct installment lending is utilized for many major recurring purchases by borrowers, and the interest payments on many of these obligations would no longer be deductible under Senate bill 2214.

In conclusion, the American Bankers Association supports the concept of tax incentives for savings embodied in section I. However, section II presents some severe difficulties to our support of the bill.

First, this section of the bill represents credit allocation imposed on the borrowing public favoring some types of borrowing with a continued interest deduction while discriminating against other important types of loans.

Second, it appears that to remove the deduction for consumer interest as proposed in this bill would impose an additional tax burden on the low and moderate income taxpayer. These are also the taxpayers who are least able to avoid the impact of the bill.

Finally, the bill's underlined premise that consumer use of credit has been a significant contributing factor to high interest rates and the so-called credit crunch that we have been experiencing is unsubstantiated by any reasonable analysis of the available economic data. That data, to the contrary, demonstrates fiscal responsibility on the part of the consumer while Government use of credit has increased markedly.

Thank you.

Senator DANFORTH. Mr. Gray?

STATEMENT OF HERBERT W. GRAY, CHAIRMAN, MUTUAL BANK FOR SAVINGS, BOSTON, MASS., ON BEHALF OF NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, NEW YORK, N.Y.

Mr. GRAY. Mr. Chairman, members of the subcommittees, my name is Herbert W. Gray. I am vice chairman of the National Association of Mutual Savings Banks and chairman of the Mutual Bank for Savings, Boston, Mass.

The National Association represents the Nation's 435 savings banks located in 16 States, with assets of $176 billion, two-thirds of which are represented by mortgage investments. Encouragement of savings, however, has always been our historic role and is our first concern today. In addition, I should point out that like many others my own bank has been very active in consumer lending for years.

I appreciate the opportunity to present the views of the savings bank industry on S. 2214, the Savings and Investment Act of 1982. Legislation to provide additional tax incentives for savings is vitally needed if we are to succeed in counterbalancing the antisaver bias that persists in our tax laws. The savings bank industry has long advocated increased incentives for savings as a means of stimulating investment, controlling inflation, and, as a result, contributing to a reduction of present intolerable budget deficits. We believe that the bill under consideration today is a well designed incentive to increase the rate of personal savings and investment, and we strongly endorse the broad objectives of the proposal.

Existing law provides for a 15-percent tax exemption of net interest income effective January 1, 1985. It should be noted that in the absence of additional legislation there will be no tax exemption or exclusion for any amount of interest earned in a depository institution beginning on January 1, 1983, with the limited exception of interest earned on so-called All Savers Certificates sold before that date.

S. 2214 should have the effect of reducing the bias in our tax laws favoring borrowers and will correspondingly increase the incentive to save by increasing the direct tax benefits thereof. To the extent that this proposal would stimulate the incentive to save immediately rather than 3 years from now, it certainly enjoys the full support of our industry.

We strongly endorse that aspect of the proposal which recognizes the importance of retaining the interest-paid deduction with respect to indebtedness incurred in the purchase of a residence or an automobile, on financing a taxpayer's trade or business or the education of his or her dependents. Recognizing the antisaver bias in the tax laws should not preclude or limit in any way the interest-paid deduction with respect to home mortgages or automobile and education loans. Credit for these longer term investments can be distinguished from the type of consumer credit for day-to-day expenditures encouraged by the buy-now, pay-later philosophy which has contributed so heavily to present intolerably high interest rates.

Equal and longer maturities on both sides of everyone's balance sheets would help to stablize our economy.

The depressed housing and automobile industries and the record number of small business failures can be directly attributed to record high interest rates brought on by excessive credit demands. Economic recovery in these critical areas would be further impeded by any limitation on the interest-paid deduction with respect to home, automobile, and business financing.

Elimination of the deductibility of consumer interest expense on a gradual basis is an equitable method of enabling taxpayers who have built up large balances of consumer debt under present tax law provisions, encouraging borrowing, to eliminate such balances over a period of 4 years. Reduction of the amount of deductible interest expense would be offset, presumably, by an increased tax advantage in savings.

While not technically the subject matter of this hearing, there are a couple of items mentioned in my written statement which we wish the committees would look at carefully because they provide some self-help to an industry which is devoted to the cause of savings.

In conclusion, the savings bank industry supports the proposal to accelerate and increase the net interest exclusion as an appropriate provision to encourage savings and to eliminate the present tax law's bias in favor of borrowers.

Thank you.

Senator DANFORTH. Mr. Cugini.

STATEMENT OF JOSEPH CUGINI, CHAIRMAN, CREDIT UNION NATIONAL ASSOCIATION, INC., WASHINGTON, D.C.

Mr. CUGINI. I appreciate the opportunity to appear before two such influential Senate Finance Subcommittees.

My name is Joseph N. Cugini, and I am the chairman of the Credit Union National Association, the credit union movement's largest trade group. I am also a credit union manager, not an economist, not an accountant nor a tax lawyer. While I lack the professional expertise of many of the other witnesses testifying before you, I have spent enough time in the financial marketplace to realize that the subject of savings is genuinely important.

Savings provide money that is invested. Investment, in turn, is necessary to raise productivity and the Nation's standard of living.

CUNA has taken an active interest in this subject since 1979, when a number of ideas for new savings incentives began circulating in Congress. In thinking about these discussions, one impression has struck me. It is that there are many theories about who in this country saves, why they save, and how they can be encouraged to save more.

There are elements of truth in all of the theories and plenty of statistics to back up those claims, but we know little for certain about what will work. I think that the message in all of this for you, our Nation's policymakers, is to go easy, tread carefully, cautiously, and lightly when trying to alter the savings and borrowing habits of your constituents.

The Savings and Investment Incentives Act of 1982 which we are discussing here today is based on a number of theories. Foremost among them is the belief that, much as schoolchildren change their route home to avoid a bully, so taxpayers will change their borrowing habits to avoid the tax man.

The measure goes further. In addition to seeking to restrain consumer borrowing, it aims to encourage savings. Speaking on behalf of CUNA, I would like to commend Senators Schmitt, Packwood, Grassley, Symms, and Mattingly for their efforts to promote thrift. Thrift has long been a principal goal of the credit union movement.

Furthermore, we endorsed the underlying approach that the authors of S. 2214 have taken toward savings incentives; that is, that savings incentives should be available to all taxpayers no matter what their income level, and they should encourage savings and investments of all types. In short, savings incentives should be general in nature and evenhanded on their effect on the marketplace.

Beyond that, though, CUNA believes that certain other proposals not contained in this measure would provide almost all taxpayers with a greater incentive to save, than the recommendation contained in S. 2214.

More importantly, CUNA opposes the provision in the Savings and Investment Incentives Act of 1982 that would eliminate the consumer debt deduction. CUNA opposes this provision on a number of grounds. I will cite just a few.

First, we believe that the use of credit is not a pernicious practice in our economy. To the contrary, the laws that Congress has passed over the last decade making credit more available to women, minorities, the elderly, and others, have enabled our credit union members to maintain or improve their standard of living.

We don't subscribe to the claim that the interest deduction is primarily responsible for the explosion in consumer credit. The underlying causes of this explosion, we think, can be more accurately attributed to other factors: (1) the movement of the baby-boom generation into the strong credit-demand stage of its life cycle, and (2) the Federal interest rate ceiling, the so-called Reg Q, which forced savers to subsidize borrowers, keeping rates artificially low.

Events in the marketplace are now causing rates to rise. The move to make credit any less attractive would create a solution to a problem which is in the process of curing itself.

The fact that other nations did not allow an interest deduction in the past perhaps indicates that the United States had an unwise policy for the 1960's and the 1970's; however, it does not prove that such a theory would be unwise in the 1990's.

CUNA opposes the elimination of the consumer debt deduction for other reasons. It seems inequitable, in our view, for Congress to remove long-standing consumer tax breaks after it recently enacted a host of new tax breaks designed to benefit businesses.

Finally, CUNA feels that the elimination of the interest deduction on revolving credit and/or credit card interest would levy a significant penalty on individuals who have no choice but to borrow to buy goods that they need.

Thank you very much. I would be more than happy to answer any questions.

[The prepared statements of the previous panel follow:]

STATEMENT OF THE
AMERICAN BANKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
SUBCOMMITTEE ON SAVINGS, PENSIONS,
AND INVESTMENT POLICY
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON S.2214
SAVINGS AND INVESTMENT INCENTIVES ACT

MAY 7, 1982

Mr. Chairman and members of the Subcommittees, my name is Robert K. Georgeson and I am Executive Vice President of the First National Bank of Lawrence, in Lawrence, Kansas. I am testifying today in my capacity as Chairman of the Instalment Lending Division of the American Bankers Association. The Association's membership consists of more than 90 percent of the nation's full service banks, including more than 12,000 community banks with deposits of $100 million or less.

We appreciate the opportunity to present our views on S.2214, the Savings and Investment Incentives Act. The Act would accomplish the following:

<u>Section 1</u>

- o Expand the percentage of <u>net</u> interest income exempted from tax in the Economic Recovery Act of 1981 from 15 to 25%.
- o Dividend income would now become eligible for the 25% exemption.
- o The effective date would be moved up from January 1,

1985 to July 1, 1982.

- o Increase the maximum exemption from $450/$900 to $500/$1000.

Section 2

- o Phase out at 25% per year the deductibility of consumer interest expense. Home mortgage interest expense, trade or business interest expense, investment interest expense, and interest expense resulting from an automobile or education loan would be unaffected by this legislation and would remain fully deductible.

As a general policy, the Association supports legislative initiatives to provide savings incentives. Indeed we applaud the savings incentives contained in Section 1 of this legislation. We have in both testimony before Congress and in correspondence to members of the Administration, advocated changes in the tax code which would provide additional impetus for savings. Specifically, the Association has supported:

- o Making permanent the exclusion of the first $200 of interest ($400 in the case of a joint return) earned by an individual taxpayer on savings deposits.
- o Increasing the tax deductible amounts which may be contributed to Individual Retirement Accounts and Keough Plans, as well as broadening participation in such plans.

It is critical to note however, that our support for tax incentives for savings is conditioned on balancing any reduction in revenue they cause. This should be accomplished generally with matching revenues from other changes in the tax laws or reductions in government expenditures, to prevent enlargement of the federal deficit. Additionally, in these times of projected 100 plus billion dollar federal deficits, deficit reduction measures should be primarily in the form of expenditure reductions. Indeed, if the appetite of the federal government for available credit were reduced, the price of credit would be eased, and a substantial portion of the bill's goal, i.e., reducing interest rates, accomplished.

The approach to offsetting losses in revenue due to the savings incentives contained in S.2214, is not the correct approach. Phasing out the deductibility of consumer interest expense for certain categories of borrowing, favors selected industries and discriminates against others. We cannot support this form of credit allocation. The approach effectively increases the cost of credit for some purposes, while favoring others. In an effort to avoid additional troubles for the ailing automobile and housing industries, it penalizes other business sectors (e.g. durable goods, home furnishings, etc.) which are also vital to the recovery of our economy.

The stated target of this legislation is mainly credit cards and revolving type interest. A recent study by the Credit Research Center, of the Krannert Graduate School of

Management, Purdue University, indicates that the cost of the proposed change in the tax code, would be borne by that segment of the population least able to avoid its impact. A copy of the pertinent section of this study is attached.

The study analyzed data collected as part of the 1977 Consumer Credit Survey and produced demographic profiles of credit card users. According to the study, card users fall into two basic categories,non-revolvers and revolvers. Non-revolvers or "convenience" users, are those who use the card to pay the full amount of their charges at the end of each month, thus avoiding the imposition of a finance charge. Depending on the timing of the purchase, these card users are obtaining what amounts to an interest free loan for up to 60 days. The other group may be described as revolvers or "credit users". These card users do not pay off their charges each month, and thus incur a monthly finance charge on the unpaid balance. The demographic profiles that emerged from the survey indicate that this bill would impact the lower and middle income brackets disproportionately.

"Convenience users" were typically better educated, had smaller families, had an annual income of $25,000 or above, and used their cards more frequently than "credit" users. In contrast to that profile, "credit users" tended to be less well educated, younger with larger families and tended to use their cards fewer times per month.

In addition, 46% of convenience users indicated that they had no trouble saving in advance for major purchases, while only 17% of credit users made that claim.

The picture thus emerges that the "credit user" is a low to middle income bracket individual with a family, who is using the credit feature of the card to maintain his family's standard of living and make major purchases for which he finds it difficult to save in advance. These credit uses are methods of financing the cost of ordinary and reasonable purchases. This certainly tends to indicate that this type of credit constitutes a necessity in the "credit user's" financial scheme, and that his demand for it is relatively inelastic. It therefore appears that this "credit user" will bear the cost of the proposed elimination of the interest deduction. It also supports the contention of many bankers that phasing out consumer interest tax deductions will not be effective in reducing borrowing levels. Rather, it will make the cost of borrowing higher for those who can least afford it.

The argument is often heard that less than one-third of all taxpayers file itemized returns and that therefore the impact of this bill will be confined to a select group of upper income taxpayers. This does not appear to be valid.

According to the recently published Internal Revenue Service Statistics of Income for 1979, 47% of all taxpayers who took a credit card interest deduction, had adjusted gross incomes of $25,000 or less. These taxpayers deducted 44% of all the credit card interest deducted in 1979.

Thus it seems clear that the lower and middle income brackets are in fact having the high cost of their borrowing somewhat ameliorated by the current interest deduction. Given the inelastic nature of the demand for this credit, the elimination of the deduction would only have the effect of increasing the effective interest rate paid by these taxpayers.

The bill would thus increase the effective cost of credit for millions of taxpayers earning less than $25,000 a year, who utilize this type of credit to maintain their standard of living. The impact of this bill, however, is not confined to credit cards and revolving credit alone. The bill targets many additional forms of credit. Revolving and credit card borrowing constitute only about one-half of consumer credit outstanding, after the deduction of the five credit categories exempted in the bill. Direct instalment lending is utilized for many major recurring purchases by borrowers, and the interest payments on many of these obligations would no longer be deductible under S.2214.

According to the statement accompanying the introduction of S.2214, there has been an "exploding demand for consumer credit". It is further stated that "the level of consumer revolving credit alone has tripled in the last five years, and this excess demand for capital drives interest rates upward". While there has been significant growth in the overall demand for credit, consumer credit has not been a significant factor in draining the credit pool.

Figures from the Federal Reserve Bulletin covering the years 1970 through 1981 indicate that as a percentage of total United States borrowings, consumer credit has, despite occasional fluctuations, remained at about 5.5% of total borrowing. An analysis of the trends in government borrowing for the same period shows a pronounced upward climb from 19% in 1970 to 27.2% in 1981. This represents a 70% increase, and a segment of the market almost five times larger than consumer borrowing.

Government Borrowing and Consumer Credit
as Percent of Total Funds Raised
in U.S. Credit Markets

	U.S. Government %	Consumer Credit %
1970	19.0	5.4
1971	18.0	6.8
1972	11.9	9.6
1973	12.3	9.6
1974	15.4	4.4
1975	45.7	2.5
1976	28.5	8.6
1977	20.6	10.4
1978	19.2	10.1
1979	18.2	9.8
1980	27.9	0.5
1981	27.2	5.5

Source: Federal Reserve Bulletin

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Any discernable upward trend in the "real" use of consumer credit would be demonstrated in a comparison of consumer credit to disposable personal income. The chart below reflects a relatively stable ratio of consumer credit outstandings to disposable personal income.

Consumer Credit Outstanding as
a Percent of Disposable Personal Income

	%
1970	20.3
1971	21.0
1972	22.0
1973	22.2
1974	21.4
1975	20.4
1976	20.8
1977	22.0
1978	23.1
1979	23.4
1980	21.2
1981	20.1*

Source: Economic Report of the President, 1982

*Credit outstanding for 1981 is through November

Thus the notion that the current credit problems are somehow related to a ballooning of consumer credit, appear to be not well founded in fact.

Conclusion

The American Bankers Association supports the concept of tax incentives for savings embodied in Section 1 of S.2214. However, Section 2 presents severe difficulties to our support of the bill. First, this section of the bill represents credit allocation imposed on the borrowing public, favoring some types of borrowing with a continued interest deduction, while discriminating against other important types of loans. Secondly, it appears that to remove the deduction for consumer interest as proposed in this bill, would impose an additional tax burden on the low and moderate income taxpayer. These are also the taxpayers who are least able to avoid the impact of the bill. Finally, the bill's underlying premise - that consumer use of credit has been a significant contributing factor to high interest rates and the so-called "credit crunch" we have been experiencing in this country - is unsubstantiated by any reasonable analysis of the available economic data. These data, to the contrary, demonstrate fiscal responsibility on the part of the consumer, while government use of credit has increased markedly.

Mr. Chairman, we appreciate the opportunity to express our views before these Subcommittees. I would be glad to try and answer any questions you might have.

Credit
Research
Center

WORKING PAPER NO. 34

Value Pricing of Bank Card Services

Krannert Graduate School of Management – Purdue University

Demand for Bank Cards for Credit Versus Convenience

As was stated at the outset, revolving bank credit has grown largely as a substitute for money balances for transactions purposes, for retail revolving credit, and other forms of instalment credit. There have been several studies of the effect of credit card ownership on the purchasing behavior of cardholders and extensive analysis of how and where cardholders use various cards.[6] However, there have been few studies [4, 20] of the characteristics of those individuals who use credit cards for the credit service feature and those who use cards for the convenience or transaction feature. In [13] Johnson analyzed the relationship between the average annual finance charge paid by a sample of bank cardholders for services received from the cards and cardholder characteristics. The annual percentage rate (APR) paid over a 12-month period was calculated by dividing the total finance charges paid by the average daily unpaid balance of the account over the period. Thus, a person who was a nonrevolver paid a zero APR for services received. Johnson found that consumers with annual incomes of $25,000 and above used their bank cards very frequently but largely avoided paying any finance charge. Johnson also found that frequency of card use (debits per month), age, and education were correlated with the level of finance charge consumers paid. The more debit services consumers used per month, the lower the APR they paid. The "high users" found bank cards to be a convenient alternative to cash, but paid little or nothing to the card issuer for the service. The older the consumer (especially the 50 and over group) the lower the effective finance rate paid. Also, the higher the level of education, the lower the APR paid.

Variables Used in Analysis

The variables included in this analysis were family income, number in household, race, education, age, an expression of the consumer's self-evaluation of his or her ability to save, the importance to the consumer of size of monthly payment relative to other instalment credit contract terms, and a measure of the frequency with which the consumer used a bank card in a month. Johnson concluded that the demographic characteristics that would be most useful in distinguishing consumers who use bank cards for credit purposes from those who hold bank cards for convenience purposes would be age, income, and education. He also found that the rate paid for bank card services was a function of the frequency of use of the card. A preliminary analysis of instalment credit use with the 1977 Consumer Credit Survey data [5, p. 95] revealed that blacks used more instalment credit per family than whites and that credit card ownership was positively related to instalment debt use. Therefore, we included a race (black, nonblack) variable in the analysis. The group means for each of the variables are shown in Exhibit 1. (A complete description of the variables is provided in Appendix A.)

Respondents who were classified as nonrevolvers had an average monthly income of $2,305 compared to an average of $1,765 for the revolver group. Compared to revolvers, nonrevolvers were significantly more likely to be 55 years old or older and to have smaller families. Forty-six percent of nonrevolvers reported that they had no difficulty in saving in advance for a major purchase compared to only 17 percent of revolvers. Thirty-nine percent of nonrevolvers indicated that size of

EXHIBIT 1

GROUP MEANS OF VARIABLES INCLUDED IN ANALYSIS

Variable	Group Means: Non-Revolvers n = 389	Group Means: Revolvers n = 395	t-statistic [a]
x_1 Monthly Income	$2305	$1765	5.60*
x_2 Difficulty in saving for major purchases (1=No)	.46	.17	9.13*
x_3 Age greater than 55	.30	.15	5.12*
x_4 Number in household	2.78	3.34	5.24*
x_5 Race (1=Black)	.03	.09	3.43* [b]
x_6 High School Education or more	.72	.69	.94
x_7 Do not consider size of monthly payment an important loan contract term	.39	.24	4.59*
x_8 Use bank card frequently	.39	.24	4.59*

*Significant at .01 level of confidence

[a]The t-statistics were calculated on the assumption that for relatively large numbers of observations a binomial distribution can be approximated by a normal distribution.

[b]The t-statistic for the race variable is significant at the 1 percent level of confidence. However, with the small proportions for race, the test of difference may not be reliable.

monthly payment was not among the first three most important credit contract terms compared to only 24 percent of revolvers who gave size of monthly payment a similar importance ranking. Thirty-nine percent of nonrevolvers indicated that they used their bank cards frequently compared to only 24 percent of revolvers. Nine percent of revolvers were black compared to only three percent of nonrevolvers. The two groups did not differ significantly in terms of the percentage that had a high school education or more.

Statistical Methodology

Multiple discriminant analysis (MDA) was used to test the extent to which a combination of this set of variables could be used to distinguish between revolvers and nonrevolvers. Discriminant analysis is a multivariate classification technique that allows the user to (1) evaluate the extent to which distinct groups differ and to describe the overlaps among groups and (2) construct classification schemes based upon the set of $\underline{m}$ variables in order to assign previously unclassified observations to the appropriate groups. The underlying assumptions of discriminant analysis are that (1) the groups being investigated are discrete and identifiable, (2) each observation in each group can be described by a set of measurements on $\underline{m}$ characteristics or variables, and (3) these $\underline{m}$ variables are assumed to have a multivariate normal distribution.

Statement
of the
National Association of Mutual Savings Banks
on
S. 2214, The Savings and Investment Act of 1982
before the
Subcommittee on Taxation and Debt Management
and the
Subcommittee on Savings, Pensions, and Investment Policy
of the
Committee on Finance
United States Senate
May 7, 1982

Mr. Chairmen and members of the Subcommittees, my name is Herbert W. Gray. I am Vice Chairman of the National Association of Mutual Savings Banks and Chairman of the Mutual Bank For Savings in Boston, Massachusetts. The National Association represents the nation's 435 savings banks located in 16 states. Their assets total $176 billion, two thirds of which are represented by mortgage investments.

I appreciate the opportunity to present the views of the savings bank industry on S. 2214, The Savings and Investment Act of 1982. This legislation would increase the amount of net interest excludable from income and would further move up the effective date for the net interest income exclusion from 1985 to 1982. At the same time it would phase out over the next four years the interest paid deduction for most types of consumer credit.

Summary of Savings Bank Industry Position

Legislation to provide additional tax incentives for savings is vitally needed if we are to succeed in counterbalancing the anti-saver bias that persists in our tax laws. The savings bank industry has long advocated increased incentives for savings as a means of stimulating investment, controlling inflation, and, as a result, contributing to a reduction of present intolerable budget deficits. We believe that the bill under consideration is a well designed incentive to increase the rate of personal savings and investment, and we strongly endorse the broad objectives of the proposal which directly address the importance of encouraging net savings. With this general endorsement, we would now like to focus on the specific aspects of the proposal.

Partial Interest Exclusion

Existing law provides for a 15 percent tax exemption of "net interest" income effective January 1, 1985. "Net interest" income is defined as the interest income earned in a given year minus any interest payments on consumer credit. Interest expenses related to residential mortgages, automobiles, and investments are not included in calculating net interest income. It should be noted that, in the absence of additional legislation, there will be no tax exemption or exclusion for any amount of interest earned in a depository institution beginning on January 1, 1982, with the limited exception of interest earned on so-called All Savers Certificates sold before that date.

S. 2214 would change the existing Internal Revenue Code provisions as follows: First, the percentage of tax-exempt net interest income would increase from 15 percent to 25 percent; second, dividend income would also become eligible for the 25 percent exemption; third, the effective date of the net interest exemption would be moved up from January 1, 1985, to July 1, 1982; and fourth, the deductibility of consumer interest expense, with the exception of residential mortgage, automobile, and investment interest expense, would be eliminated on a gradual basis, with 75 percent of such interest expenses deductible beginning July 1, 1982, 50 percent deductible in 1983, 25 percent deductible in 1984, and the deduction entirely eliminated in 1985 and beyond, with the stated exception of residential mortgage, automobile, and investment interest.

The proposed increase in the percentage of tax-exempt net interest income, as well as the proposed increase in the amount of exempt net interest income, should have the effect of reducing the bias in our tax laws favoring borrowers and will correspondingly increase the incentive to save by increasing the direct tax benefits thereof. Redressing the existing inequity of favoring the borrower over the saver will be further facilitated by advancing the effective date of the net interest exemption from 1985 to 1982. To the extent that this proposal would stimulate the incentive to save immediately, rather than three years from now, it certainly enjoys the support of our industry.

Mortgage, Automobile, and Investment Interest Exception

We strongly endorse that aspect of the proposal which recognizes the importance of retaining the interest paid deduction with respect to indebtedness incurred in the purchase of a residence or an automobile or in financing the taxpayer's trade or business or the education of his or her dependents. Recognizing the anti-saver bias in the tax laws should not preclude or limit in any way the interest paid deduction with respect to home mortgages, automobile, and education loans. Credit for these longer term expenditures can be distinguished from the type of consumer credit for day-to-day expenditures encouraged by the buy-now, pay-later philosophy which has contributed so heavily to present intolerably high interest rates.

The depressed housing and automobile industries and the record number of small business failures can be directly attributed to record high interest rates brought about by excessive credit demands. Economic recovery in these critical areas would be further impeded by any limitation on the interest paid deduction with respect to home, automobile and business financing. Education loans have also been an unfortunate casualty of excessive credit demand, high interest rates, and record budget deficits. Credit for educational purposes should not be further impeded by a limitation on the interest paid deduction, and we endorse the recognition of this in the proposal.

Phase-In of Elimination of Consumer Interest Expense

Elimination of the deductibility of consumer interest expense on a gradual basis is an equitable method of enabling taxpayers who have built up large balances of consumer debt under present tax law provisions encouraging borrowing, to eliminate such balances over a period of four years. Reduction of the amount of deductible interest expense would be offset, presumably, by the increased tax advantage in savings. Given the present high level of consumer debt, elimination of the deduction of consumer interest expense immediately would work an undue hardship on those least able to save in today's inflationary environment. Further, it would presumably limit the advantages of the net interest exclusion to those upper income taxpayers who have been able to avoid larger accumulations of consumer debt, with the result that little new savings would be generated. The proposal would avoid this inequitable and unproductive result.

Other Issues

Although not technically the subject matter of this hearing, there are two other tax issues that we would like to bring to the attention of the Subcommittees. The first is an inequity in the tax laws which should be addressed with any proposal relating to the taxation of thrift institutions. Mutual savings banks and savings and loan associations are limited under Section 46(e) of the Internal Revenue Code to an allowable investment credit equal to one-half of that permitted to other corporations, including commercial banks.

It is the position of our industry that this limitation on the investment credit available to thrift institutions has no justifiable basis as a matter of public policy, particularly, in view of the decreased significance of the special bad debt deduction for residential mortgage investments. Today, most savings banks do not utilize the special bad debt deduction and compute their reserve for bad debts and ultimate tax liability in the same manner as other corporations, including commercial banks, which all utilize the full benefits and incentives of the investment tax credit.

The arbitrary limitations imposed upon savings banks and savings and loan associations become apparent with reference to recent developments in the field of electronic banking--an area which is only beginning to realize what will be major innovations in all areas of banking. By its nature, electronic banking and electronic funds transfer involve significant investment in computers and other costly equipment. The savings bank industry would suffer a crucial disadvantage in its efforts to compete with commercial banks and other financial conglomerates, such as Sears and Merrill Lynch, in the emerging area of electronic banking if we are unable to utilize the same investment opportunities as commercial banks and other corporations which are entitled to 100 percent of the investment tax credit.

In this connection, we would request that the Subcommittees favorably consider the repeal of Section 46(e) of the Internal Revenue Code and thereby eliminate the limitation on the use of the credit by thrift institutions.

We would also call to your attention a problem which exists with respect to discounts on mortgage redemptions. Mutual savings banks, in an effort to restructure their mortgage portfolios, have increasingly offered mortgagors the opportunity to pay off low-rate mortgages at substantial discounts, thereby making available funds for housing and other investments at current rates. The ability to accomplish this important program has been hindered by uncertain tax consequences to the mortgagor as a result of these transactions. The savings bank industry urges the Subcommittees to consider legislation which would make it clear that the retirement of mortgage obligations prior to maturity at a discount does not result in taxable income to the mortgagor. Such a determination would have little if any revenue impact to the Treasury while at the same time would contribute to relieving current pressures on the thrift industry. Low-yielding mortgage portfolios are, without question, the root cause of the current crisis in our industry, and enhancement of the ability to restructure those portfolios will help avoid the much larger federal expenditures, which will be required in dealing with financially distressed thrift institutions.

Conclusion

In conclusion, the savings bank industry supports the proposal to accelerate and increase the net interest exclusion as an appropriate provision to encourage savings and eliminate the present tax law's bias in favor of borrowing. I would be pleased to answer any questions you may have at this time.

TESTIMONY OF JOSEPH N. CUGINI, CHAIRMAN, CREDIT UNION NATIONAL ASSOCIATION, INC.

I appreciate the opportunity to appear before the Senate Subcommittee on Taxation and Debt Management and the Subcommittee on Savings, Pensions and Investment Policy to discuss "The Savings and Investment Incentive Act of 1982" (S. 2214). My name is Joseph N. Cugini, I am chairman of the Credit Union National Association, the credit union movement's largest trade group. The subject of savings is genuinely important, for savings provide money that is invested. Investment, in turn, is necessary to raise productivity and the nation's standard of living.

CUNA has taken an active interest in this subject since 1979, when a number of ideas for new tax breaks to encourage savings began circulating in Congress.

CUNA's comments on this topic are divided into 4 sections. First, I will offer some general comments on the question of savings incentives. Part 2 contains a discussion of some of the general premises underlying S. 2214, and Part 3 will examine the impact of certain provisions of this measure. Part 4 will discuss "netting".

MALAISE AND THE SAVINGS RATE

Scarcely a month goes by without one social commentator or another lamenting the unwillingness of Americans to save. There is no question that Americans save less of their money now than they did at the beginning of the 1970s. It is also true that Americans are less thrifty than other people in the Western world.

Beyond these two points, however, any discussion of why Americans are saving less and what should be done about it quickly evolves into a contentious and inconclusive dust storm of economic statistics and psychological diagnosis.

One camp of experts claims that the reasons and amounts people save have more to do with personal circumstances -- whether they have children to educate, for example, than the financial yield that their savings will generate. Members of this group argue that since a heavy portion of the population is of an age when they need and want to buy houses, furniture, appliances, cars, education, vacations, etc., it follows that the nation's savings rate should decline. They argue that the savings rate will pick-up when the baby boom generation begins to pass out of the household formation stage and into the savings stage of its life cycle in the late 1980s.

Other experts, of course, see things differently. They posit that the real rate of return on savings is the stimulus that drives the savings rate up or down. They argue that if you increase the real (adjusted for inflation) after-tax rate of return on savings, people will spend less and save more. One way to increase the real after-tax yield on savings is to reduce taxes. Do so, says this group, and taxpayers will substitute saving for spending, working for leisure, opening a business for buying into a tax shelter.

Congress has, in fact, enacted programs, most notably the Economic Recovery Act of 1981, designed to test this premise, but the results to date aren't conclusive and are not likely to become so for quite some time.

Others believe that traditionally people save for specific reasons -- two of the strongest reasons being to provide for old age and for illness. They suggest that health insurance and social security have mitigated these anxieties. They contend that improvements in Social Security benefits, in particular, have induced people to save significantly less than they otherwise would have done. Congress, however, has to date rejected suggestions to cutback on Social Security payments, despite the program's chronic financial troubles.

One problem with all of these theories is that they are difficult to test and the results even harder to verify because the economy contains too many unknown and unpredictable variables. A proposal that makes sense and promises results when prices are rising doesn't have the desired result when it's put into operation and prices subsequently have stabilized or perhaps begun to fall. Furthermore, historical cause and effect relationships may not accurately predict what the future will bring. All economic actors learn from experience, and experience teaches different lessons.

In short, then, there exist many theories about who saves, why they save and how they can be encouraged to save more. There are elements of truth in all of the theories and statistics to back up many claims. The clear message in all this for policymakers is to tread carefully, cautiously and lightly when trying to alter consumers' saving and borrowing habits.

GENERAL THEORIES UNDERLYING S. 2214

"The Savings and Investment Incentives Act of 1982" (S. 2214) is based on a number of theories. Foremost among them is the tenet that taxpayers' behavior is influenced by the tax code and that by changing the code you can stimulate people to alter their behavior.

Much as school children change their route home to avoid a bully, so taxpayers will change their borrowing habits to avoid the tax man. At least this is the basic idea underlying S. 2214.

The measure goes further. In addition to seeking to restrain consumer borrowing, it aims to encourage savings.

While neither subscribing to nor questioning the validity of the theory that consumer borrowing and saving habits can be influenced by altering the tax code, CUNA supports the savings incentive provisions of S. 2214.

Senators Schmitt, Packwood, Symms, Grassley and Mattingly correctly advocate the philosophy that incentives of this nature should be general and as neutral as possible toward industries tax brackets.

We endorse the evident belief of Senator Schmitt et al that savings incentives should be as general as possible. In other words, they should be available to all taxpayers, no matter what their income level, and should encourage savings and investment of all types.

However, while CUNA endorses the efforts of Senators Schmitt, Packwood or others to promote thrift -- a founding principle of the credit union movement -- we oppose their efforts to discourage borrowing.

The use of credit is <u>not</u> a pernicious practice in our economy. To the contrary, the laws that Congress has passed over the last ten years making credit more available to women, minorities, the elderly and others previously discriminated against have enabled our credit union members to maintain or improve their standard of living. The availability of credit has also enabled them to weather such unexpected occurances as medical emergencies or job lay-offs. Congress has recognized the important role that credit has and continues to play in our economy and has sought to extend, rather than to restrain its use.

CUNA opposes the elimination of the consumer debt deduction in principle on a number of other grounds. First, it seems inequitable for Congress to revoke a long-standing consumer tax-break after it has recently enacted a host of new tax-breaks designed to benefit business. Second, it is not at all clear to CUNA that the present tax law as it relates to the interest rate deduction discriminates as heavily against lower income groups to the degree that the sponsors of this measure seem to believe.

In the Congressional Record of March 16, 1982, Senator Schmitt has noted that the consumer debt deduction discriminates against those who do not elect to itemize deductions on their tax returns. This is true. By the same token, it is also true, according to IRS figures, that roughly 70% percent of all taxpayers do not itemize. However, it would be just as true to say that the tax code discriminates against people who don't own their own homes, since they would be significantly less likely to itemize their tax deductions. Such aggregates obscure the fact that about 25 percent of all taxpayers with adjusted gross incomes of between $10,000 and $20,000 itemize their deductions. Similarly, more than 50 percent of taxpayers with adjusted gross incomes of between $20,000 and $25,000 itemize their deductions.

These people will lose a valuable tax break if S. 2214 is enacted. For them, borrowing will become more expensive. Are these the so-called "higher income groups" Congress seeks to restrain by eliminating the consumer debt deduction? As presently written, CUNA believes this is so and for that reason, too, we do not support this provision of the bill.

The claim that the U.S. is the only country to allow an interest deduction is correct. However, the claim that it is a primary cause of the explosion in consumer credit outstanding is not valid. The underlying causes of this explosion were the facts that: 1) the baby boom generation was moving into the stage of strong credit demand and 2) Reg Q ceilings "forced" savers to subsidize loan rates.

Events in the marketplace are causing market interest rates on savings to increase, and loan rates along with them. This "market" incentive is reducing the attractiveness of debt. The leading edge of the baby boom generation will begin entering the savings stage of its life cycle in the late 1980s.

Any move to make credit further less attractive or savings more attractive (except perhaps IRAs which are designed to allow revisions in social security) will create a solution to a problem which is in the process of curing itself. The fact that other nations did not allow an interest deduction in the past perhaps indicates that the U.S. had an unwise policy for the 1960s - 1970s. However, that does not demonstrate that such a policy would be wise in the 1990s.

ANALYSIS OF THE IMPACT OF S. 2214

S. 2214 appears to benefit upper/upper-middle income households as compared to middle/lower-middle income households.

Specifically:

1. In order to receive the maximum benefit of the $1,000 interest exclusion, a family filing a joint return would have to earn $4,000 in interest/dividends. This would require investments in the $25,000-$40,000 range. Thus, it is unlikely that the typical taxpayer would realize the maximum benefit. However, the bill does provide an incentive for further savings.

   a) Depending upon how you define it, S. 2214 does/does not provide as great a savings incentive as found in ERTA '81. The stronger incentive is found in the fact that the individual receives a 25% interest exclusion compared to a 15% exclusion in ERTA, thus, making additional interest income more attractive. However, the incentive ends at $4,000 in interest earned rather than the $6,000 in ERTA thus lowering the amount of savings/investment required to earn the maximum amount of interest upon which the exclusion can be earned.

   b) When compared to the fact (except as noted below) 100% of interest is currently taxed, taxing only 75% of interest earned does provide some incentive to accumulate additional savings. The magnitude of the incentive increases as the taxpayers' marginal tax rate increases. However, for almost all taxpayers, the proposal to tax interest/dividends separately with their own tax schedule would provide a greater incentive than S. 2214.

c) Compared to the current $200/$400 interest exclusion, S. 2214 is unlikely to offer any benefit to the average taxpayer. Today, an investment of approximately $3,500 will generate sufficient interest/dividends to earn the maximum exclusion (however, there is no tax incentive to add further savings). If S. 2214 were operational, the interest exclusion on these earnings would automatically fall to $100. If we make adjustments for interest paid on certain types of consumer debts, the exclusion in all likelihood would fall to zero -- even if savings were increased dramatically.

2. The move to "neutralize" and/or "eliminate" certain interest deductions suggests that many taxpayers, particularly those who are financing an auto (stock purchase on margin or education loan) will be unlikely to realize any interest exclusion. Individuals in middle income levels will have a checkered pattern of interest exclusions - receiving one only when they are almost completely free of consumer debt.

3. Elimination of the interest deduction on revolving/credit card interest creates a significant penalty (rather than a severe disincentive to purchase on credit) for individuals who must purchase on credit. Every dollar of interest paid reduces the interest exclusion by $.25 (this, of course, would not be true for individuals who earned interest in an amount equal to $4,000 plus the amount of interest paid).

In addition, the individual's tax payment would increase in an amount equal to the dollar amount of interest paid times the individual's marginal tax rate.

4. S. 2214 would pose interesting questions for reporting and interpretation. More and more lenders are moving to secure credit with real property to reduce the potential for bankruptcy losses. Does the use of real property as security make this a mortgage loan for tax purposes? I assume the answer is "no." However, what about the case where the mortgage loan was granted/increased to allow for the purchase of household durables (or even an auto). In this instance, the payment of interest (on a dwelling) would not reduce the interest exclusion of the individual whereas they would if they were financed in some other manner. (Properly structured, this could provide a real bonanza for savings and loan associations in their attempt to expand into consumer credit.)

Credit unions often have open-end loan agreements which allow the member to finance the purchase of an automobile. If the interest deduction were removed for "revolving" credit, credit unions would be required to find some way to separate the interest paid into separate components and find that it is impossible to do so.

Forcing individuals to "net" various types of interest paid (except mortgage/business) would further point up the advantage received by certain professionals (doctors, etc.). If they incorporate certain interest expenses become an allowable business expense. These same interest expenses would be a consumer interest expense for the average consumer. In short, they will be able to take advantage of the law.

DISCUSSION OF "NETTING"

One of the premises implicit in S. 2214 is that the tax code should not contain both incentives to save as well as incentives to borrow. CUNA does not agree.

We believe that it is entirely appropriate for the tax code to contain exclusions for interest earnings and for interest expenses. However, it may not be desirable to permit taxpayers to use both simultaneously. Senator Schmitt's earlier proposal which became section 302 of the 1981 Economic Recovery Tax Act recognizes this as did Congress when it included this proposal in the law.

Section 302 of the Tax Recovery Act denies the 15% interest tax exclusion to individuals who also have interest expense on a dollar for dollar basis. In other words, only individuals who save more than they borrow may receive a tax break and then only to the degree to which interest earnings exceed interest expenses. (Debts incurred for certain purposes are exempt from the computations of interest expense in both bills.)

Under Section 302 of the 1981 Tax Act, taxpayers who itemize must calculate their "net" interest earnings. This "netting" is the way that Congress has sought to use the tax code to maintain a balance between saving and borrowing. For those taxpayers who don't itemize, the saving incentive is available without using the interest expense exclusion also.

CUNA recommends that if this panel wants to stimulate savings more quickly than it originally felt was necessary, it could move up the starting date of Section 302 ERTA from 1985 to 1983. Any adverse consequences on the federal budget could be reduced by repealing the $100/$200 dividend exclusion that is scheduled to be reinstated in January, 1983.

Clearly, S. 2214 has as one of its secondary aims to simplify our confusing tax code. CUNA believes the measure, as it's now written, would not simplify the tax code. Instead, taxpayers would have to identify at least six types of credit in order to determine accurately the taxes that they owe.

Under S. 2214, interest expenses on debts incurred for certain purposes (home purchase, carrying on a trade or business) are deductible and exempt from netting. Interest expenses on other types of debts (auto purchase, education and investment) are deductible, but must be netted against interest earned on savings. Interest expenses on all other types of credit cannot be deducted and under the measure, as it is now written, and must be netted against interest and dividends.

While S. 2214 is appropriately general and neutral in its design of savings incentives, it is regrettably particular in selection of certain categories of consumer debt for favorable tax treatment. Such preferential treatment is bound to encourage Americans to incur debt for certain expenditures and not others and will mean that credit will be allocated to certain sectors of the economy and not others.

CUNA does not believe that this is the proper role of the government but should be left to individuals and the marketplace.

Senator DANFORTH. I want to thank you very much. I have just one question for all of you.

When we enacted the 1981 act, we believed that we should have some incentives for personal savings, and then we did so with the individual retirement accounts and the all savers certificates.

I take it that the testimony of each of you is that we should be considering the question of savings incentive interest. I would guess, with the expiration of the all savers imminent, that that might provide a greater impetus to our considerations.

Do you believe that the Congress should be addressing itself to the question of savings incentives, and especially to the question of the use of the tax laws as a possible means of reducing your problems?

Mr. GEORGESON. Yes, and our association has supported tax incentives for savings, but conditioned on balancing any reduction in revenue they cause, with matching revenues from other changes in the tax laws or reductions in Government expenditures.

Mr. GRAY. I don't think there is any question that it is important that Congress address this question at this point in time. There are, of course, the all savers certificates out there with about $40 billion in it that is going to start phasing out, but that needs to be rolled over with something.

Mr. CUGINI. The credit union movement believes that. In fact, I had the honor of testifying before Senator Chafee's committee here on the IRAs; in fact, the expanded version which included down payments for housing and education.

Senator, If I may, we certainly agree with the tax incentives; but, again, just the other side of that question, about the deductibles, I have in front of me this morning the unemployment figures that have come out, and we have moved from 9 percent to a 9.4-percent unemploment rate. Phasing out the deductibility of consumer interest expense for certain categories kind of discriminates against others.

In an effort to avoid additional troubles for the ailing auto and housing industries, it penalizes other sectors such as durable goods, home furnishings, and others, which also are vital to the recovery of the economy. It says, "The rise in unemployment was felt most heavily by workers in the construction and durable goods manufacturing industries. The unemployment rate for blue-collar workers rose to 13.7 percent in April, up from 9.5 in July." I just happened to think that maybe this is just adding more burden onto that particular group.

Senator DANFORTH. Thank you all very much.

Mr. GEORGESON. Thank you, Mr. Chairman.

Mr. GRAY. Thank you, Mr. Chairman.

Mr. CUGINI. Thank you.

Senator DANFORTH. Our next witnesses will be a panel consisting of William Tartikoff and Edward O'Brien.

Mr. Tartikoff, will you proceed?

STATEMENT OF WILLIAM TARTIKOFF, ESQ., ASSISTANT COUNSEL, INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Mr. TARTIKOFF. Thank you, Senator.

My name is William Tartikoff. I am assistant counsel of the Investment Company Institute, the national association of the American mutual fund industry.

S. 2214 would extend the partial exclusion of interest income to dividends received by individuals, whether received directly or through mutual funds. On behalf of the millions of shareholders of mutual funds, the institute strongly supports this provision.

S. 2214 is designed to provide a real and effective incentive for the public to increase its rate of personal savings and investment and has the objective of increasing the availability pool of national capital.

It seems self-evident that incentives for savings and investment should be directed toward the supply of equity capital for the Nation's industries to no less extent than the acquisition of interest-bearing indebtedness.

Not only does the Nation face a difficult problem in increasing the total level of savings and investment, but equity investment has particularly suffered in recent years. The experience of our members shows that to the extent moneys are available for investment the flows have been into debt instruments rather than into equity capital that is so sorely needed by industry.

In the decades of the 1950's and the 1960's, roughly 87 percent of mutual fund assets were in funds which invested in common and preferred stock. At the end of 1981 this figure had fallen roughly to 67 percent.

Sales figures show the same picture. In 1968, 84 percent of the dollar volume of mutual fund shares sold to investors were shares in equity-oriented funds; but by year-end 1981 this figure was only 59 percent.

It should also be noted that the figures I have just cited are stated without the inclusion of money market fund statistics.

Equity capital furnished for common and preferred stocks provides the lifeblood for American industry, the principal source of jobs, and the foundation of our economic structure. It is of the utmost importance that individual investors be given new encouragement to direct their savings in the future growth of our industries by supplying them with equity capital. Incentives directed solely or primarily toward interest-bearing indebtedness would wrongly tilt the scales further toward debt financing.

The mutual fund industry offers a full spectrum of funds—mutual funds that invest in common stocks as well as funds that invest in debt instruments. We believe that our shareholders who hold shares in mutual funds investing in common stocks should be entitled at least to the same exclusion as they would if a mutual fund invested in debt instruments.

Our data shows that almost 80 percent of the dividends received by persons investing in equity-oriented mutual funds are reinvested in additional shares of the mutual funds, demonstrating that those persons are long-term savers and investors. Current law may act to actually discourage these shareholders and persuade them to switch their investments from equity to debt.

Indeed, it is sound tax policy to provide a higher exclusion for dividends received by individuals than for interest so received. Businesses paying interest on their outstanding indebtedness are permitted a deduction for the interest; hence, when the interest is included in taxable income of the individual payee, the individual alone is paying tax on that amount. By contrast, for business corporations paying dividends, those dividends are subject to a double tax—once to the corporation, and then again to the shareholder.

In recognition of these circumstances an exclusion of $50 per person for dividends received plus a small credit was enacted in 1954. In 1964 this was changed to a $100 exclusion. Thus, the partial exclusion for interest provided by the 1981 Tax Act, which allows a much higher exclusion for interest received than for dividends received, fails to take into account the long-recognized factor of double taxation of corporate income and mistakenly provides a savings incentive for investments in interest-bearing indebtedness that does not extend to dividend-paying stock.

Accordingly, Senator, the institute respectfully submits that the exclusion for dividends received should be no less than the exclusion for interest received and therefore urges the enactment of S. 2214 to achieve this result.

Thank you very much.

Senator DANFORTH. Mr. O'Brien.

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

Mr. O'BRIEN. Good morning, Mr. Chairman.

I am Edward I. O'Brien, president of the SIA. Our purpose in being here today is to express our support for the basic thrust of Senate bill 2214.

Our support is based on the conviction that the bill addresses an important and very basic need in a commonsense fashion. That need is to rebuild capital, investment, and employment in our country so that we are able to correct the neglect in these areas which covers so many years. We believe that a reemphasis on saving and investment will do much to achieve these basic and important goals.

Furthermore, we believe that the bill's purpose in accelerating the effective date to 1982, coupled with the equal treatment of income from interest and dividends, is the correct approach to the overall national need for investment.

The bill's purpose can be achieved while increasing government revenues by $5 billion through 1985. Personal tax receipts fall slightly during the first years the proposal is in effect; however, the gain for 1984 and 1985 more than offsets the prior years' losses. The small reduction in 1982-83 revenues could be eliminated if the repeal of consumer interest deductions were not phased in. The proposal reduces the Federal deficit by $5 billion through 1985. These projections are based on a simulation prepared at our request by Data Resources, Inc.

Through 1985, Senate bill 2214 will increase real GNP, investment, savings, and consumption, and we have reflected this in table 5 on page 15 of our written statement.

These projections were reached without making any assumptions about the effect of the proposal on stock prices. If even a modest 2-percent increase in the S. & P.'s 500 index is assumed, the results are dramatic. Real GNP would increase by $10½ billion, savings would increase over $3 billion, Federal tax revenues would rise $12 billion, and the deficit would be reduced by over $14 billion.

While the comparisons between our country and others are often difficult to make and require explanation, the crafting of legislation with as important a goal as S. 2214 should take such matters into consideration. The study which Arthur Andersen & Co. did at the request of SIA is reflected on page 7 of our written statement and is quite persuasive. These comparisons show a clear disparity between most of the industrialized nations of the world in their savings and investment rates with those of the United States. This results because of differences in the tax treatment of interest and dividend income. Our recommendation is that these serious disparities be brought into line so that our citizens may be treated equitably compared with those of other countries.

Finally, based on our experience in these matters, we have attempted to demonstrate in our written statement several basic national trends which we consider to be unsatisfactory.

One. Economic growth, which is really essential for the overall well-being of our fellow citizens has lagged very significantly over the last 12 years. That condition must be addressed, and we must find a commonsense solution.

Two. Gains in labor productivity have lagged very seriously in the last 15 years and in fact were negative in the years 1978–80. Much of the decline is attributable to a deterioration in our capital investment stock. This is something which must be reversed if we are to grow and provide additional jobs in the future.

These declines in economic growth and productivity reflect a deemphasis of savings and investment in our country. We must reverse this trend if we are to return to a course of greater opportunity in the future. Again, we believe that this bill addresses these concerns.

The final point concerns our special area of experience, namely, raising capital. Our written statement sets forth business' special needs for capital in order to expand and serve markets and to increase employment.

Debt/equity ratios of corporations have become unbalanced. Debt alone has doubled in just 7 years. Federal tax policy favors an undue emphasis on debt rather than maintaining tax neutrality between debt and equity financing. We believe that S. 2214 does address these basic questions, and, once again, we support it.

If you have any questions, we would be pleased to try to answer. Thank you.

[The prepared statements of the previous panel follow:]

STATEMENT OF WILLIAM M. TARTIKOFF
ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT AND
SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY
CONCERNING S. 2214

May 7, 1982

My name is William M. Tartikoff. I am Assistant Counsel of the Investment Company Institute, on whose behalf I appear today.

The Institute is the national association of the mutual fund industry. Its membership includes more than 650 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of more than $240 billion, and have approximately 18 million shareholder accounts.

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. Mutual funds provide an economical way by which investors can obtain professional advice and diversification of investments. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of the dividends, interest and net capital gains generated by the fund's investment, less the fund's operating expenses, such as investment advisory, custodial and accounting fees.

The Economic Recovery Tax Act of 1981 provides for the partial exclusion of interest received by individuals in years beginning after 1984, and provides that interest received by mutual funds and distributed currently to their individual shareholders will be eligible for this exclusion. The pending bill, S. 2214, introduced by Senator Schmitt, would extend this partial exclusion to dividends received by individuals, whether received directly or through mutual funds. On behalf of the millions of shareholders of mutual funds, the Investment Company Institute strongly supports the extension of this provision to dividends.

The Internal Revenue Code presently allows each individual to exclude from gross income $100 ($200 on a joint return) of dividends received from domestic corporations. That section of the law traces back to 1954 when it was enacted as part of an effort to ameliorate somewhat the double taxation of corporate income, once to the corporation and again to its shareholders when distributed to them as dividends. In the Windfall Profit Tax Act of 1980 the amount of this exclusion was doubled and enlarged to encompass investment interest as well. Then in 1981, when the so-called "all-savers" tax-exempt interest provision was enacted as a temporary measure, the dividend exclusion was cut back to the previous amount of $100 ($200 on a joint return) and a separate exclusion for interest in a larger amount was enacted, effective for 1985 and subsequent years. S. 2214 would combine the two exclusions, and make the combined exclusion applicable both to dividends and interest received. In addition, S. 2214 would increase the percentage exclusion from 15 percent to 25 percent of dividends and interest received; would increase the maximum exclusion from $450 to $500 per individual (from $900 to $1,000 on joint returns); and would advance the effective date of the exclusion from 1985 to 1982.*/

The Institute firmly believes that the exclusion for dividends received should, at the least, be no less favorable to individuals than the exclusion for interest received. As Senator Schmitt stated in introducing S. 2214, the bill "is designed to provide a real and effective incentive for the public to increase its rate of personal saving and investment." It has the objective of "increasing the available pool of national capital." The Institute believes it is self-evident that incentives for savings and investment should be directed toward the supply of equity capital for the nation's industries to no less extent than the acquisition of interest-bearing indebtedness.

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*/ Another provision of S. 2214 would disallow deductions by individuals for interest paid other than interest related to a personal residence, automobiles, a trade or business carried on by the taxpayer, higher education expenses or investments.

Not only does the nation face a difficult problem in increasing the total level of savings and interest, but the experience of the Institute and its members shows that investment funds are flowing into debt instruments rather than into equity capital that is so sorely needed. In the decades of the 1950's and 1960's, roughly 87 percent of the assets of the Institute's member funds were invested in common and preferred stocks. At the end of December 1981, this figure had fallen to roughly 67 percent. An even more drastic decline is shown by the fact that in 1968 the dollar volume of sales to investors of shares in equity oriented funds represented about 84 percent of the dollar volume of all new sales of mutual fund shares; but by December 1981, this figure was only 59 percent. It should be noted that these figures are stated without inclusion of money market funds, which invest solely in short-term debt instruments.

Equity capital furnished for common and preferred stocks provides the life blood of American industry, the principal source of jobs and the foundation stone of our economic structure. It is of the utmost importance that individual investors be encouraged to direct their savings in the future growth of our industries by supplying them with equity capital. Incentives directed solely or primarily toward interest-bearing indebtedness would tilt the scales further toward debt financing. We believe it imperative that, at the least, savings incentives should extend to equity investments as well as to investments in debt obligations.

The mutual fund industry offers to the public mutual funds that invest primarily in common stocks, other funds that invest primarily in debt instruments and still others that hold both types of investments. We firmly believe that those individuals who hold shares in mutual funds investing in common stocks should be entitled at least to the same partial exclusion for federal income tax purposes as they would have if the mutual fund invested in debt instruments. Our data show that almost 80 percent of the dividends received by persons investing in equity oriented mutual funds are reinvested in additional shares of the mutual funds, demonstrating that those persons are long-term savers and investors.

Indeed, there is reason both in tax policy and in history to provide a higher exclusion for dividends received by individuals than for interest so received. Businesses paying interest on their outstanding indebtedness are permitted a deduction for the interest in computing their federal income tax; hence when the interest is included in taxable income of the individual payee, the individual alone is paying tax on that amount. By contrast business corporations are not allowed deductions for dividends paid to shareholders, and yet the dividends are income to the recipient. Absent some adjustment, corporate income distributed to shareholders as dividends is twice taxed -- once to the corporation and then again to the shareholder.

In recognition of these circumstances an exclusion of $50 per person for dividends received was enacted in 1954 and raised to $100 in 1964. Thus the 1981 provision allowing a much higher exclusion for interest received than for dividends received fails to take into account the long recognized factor of double taxation of corporate income, and mistakenly provides a savings incentive for investments in interest-bearing indebtedness that does not extend to dividend-paying stock.

Accordingly, the Institute respectfully submits that the exclusion for dividends received should be no less than the exclusion for interest received, and urges the enactment of S. 2214 to achieve that result.

Statement of the Securities Industry Association

Mr. Chairman and members of the committee, I am Edward I. O'Brien, and I am appearing today as President of the Securities Industry Association. I appreciate the opportunity to participate in the committee's hearings on S. 2214, the Savings and Investment Incentives Act of 1982.

SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 32 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

INTRODUCTION

U.S. economic growth as measured by real GNP slowed from an annual average of 5 percent in the 1960s to 3.6 percent in the 1970s. Within the first two years of the 1980s, the U.S. has experienced three quarters of negative growth. The 1980 recession dampened annual real GNP by a negative 0.2 percent, while in 1981 the economy expanded at a meager 2 percent.

Tight monetary policy used to combat rampant inflation has had a measure of success. The inflation rate subsided from 13.3 percent in 1979 12.4 percent in 1980 to 8.9 percent in 1981. Nevertheless, the high interest rates accompanying restrictive monetary policy have hampered economic growth and employment and blunted the effectiveness of fiscal policy measures.

Gains in labor productivity have almost become a phenomena of the distant past. The increase in average annual productivity, more than 3 percent in the 1947-65 period, slowed to well under 3 percent between 1965-73, and dropped to under 1 percent in the 1973-79 period. In fact, productivity was negative for three consecutive years -- 1978, 79, and 80 -- the first time for such a distressing experience since data collection began in 1909. Minimal gain was recorded in 1981. Preliminary first-quarter 1982 statistics show a slight 0.3 percent annual gain in productivity, but the annual rate in both the private business and farm sector dropped 1.4 percent as measured from first quarter 1981. The downtrend in productivity in part reflects a deterioration in our capital stock. Between 1945 and 1973, the average age of structures dropped steadily from 21.6 to 13.4 years. The average age of equipment followed a similar trend, declining from 10.2 years in 1935 to 6.3 years in 1974. Since the mid-1970s, modernization of equipment and structures has come to almost a dead halt.

The average annual growth rates of nonresidential fixed investment offer much of the explanation for the antiquation of our industrial base. Real nonresidential fixed investment in the 70s averaged less than half the 8.4 percent growth in the 60s. Moreover, real fixed investment declined by 3 percent in 1980 and inched up by only 1.7 percent in 1981.

To arrest these discouraging trends, it is important to increase this nation's pool of savings. Savings provides the wherewithal for the updating of plant and equipment and the implementation of new technology. The depressed savings rate in the U.S., only 5.3 percent in 1981, underscores the urgent need to provide incentives for increased savings.

INTERNATIONAL ECONOMIC COMPARISONS

The U.S. fares poorly in any international comparison of economic trends. The loss of our once-preeminent international position has exacerbated our economic problems, taking its toll in lost production, lost jobs and costly imports. With the exception of Canada, the annual compound rate of productivity gain in the U.S. is the lowest of the major industrialized countries as shown in Table 1.

The U.S. showing in terms of productivity gains are echoed in terms of savings and investment. Personal savings is an essential link to corporate capital formation; a low level of savings precludes a high level of capital investment and severely limits productivity gains.

TABLE 1

Productivity Gain in Manufacturing

1977-1980

(Compound Annual Rate)

Japan	7.4%
Italy	5.6
Netherlands	5.1
France	3.8
Germany	3.5
United Kingdom	2.3
U.S.	0.6
Canada	0.4

SOURCE: U.S. Department of Commerce

The savings rate of six major foreign countries far exceeds that of the U.S. Moreover, the recent savings rate of five of these countries shows an increase from the 1970 level that is dramatic in some cases. In contrast, the savings rate in the U.S. has fallen precepitously from 8.0 percent in 1970 to 5.3 percent in 1981. Similarly, real investment as a percentage of total output is impressively higher in foreign countries. The U.S.'s last place position in terms of savings coincides with its last place position in terms of real investment. (See Table 2)

There is a close link between savings and investment. While the Economic Recovery Tax Act of 1981 provided some stimulus for savings, many foreign industrialized nations provide far greater incentives to save and invest than the U.S.

INTERNATIONAL TREATMENT OF INTEREST AND DIVIDENDS

In a survey conducted by Arthur Andersen for SIA, the tax treatment of individuals' dividend and interest income in 10 foreign countries was reviewed. Not only do many of these foreign countries apply lower marginal tax rates to dividend and interest income, but many also provide more generous special allowances and exemptions. (See Table 3)

Most notable in a comparison of U.S. policy with foreign countries is the lack of a direct or indirect integration system to mitigate the double taxation of dividends, first at the corporate level, and then again at the shareholder level. Seven

TABLE 2

	Real Investment as a % of Real National Output 1974-1980 1/	Savings as a % of Disposable Personal Income 1970	1981 2/
Japan	23.8%	18.2%	19.4%
Canada	17.3	5.3	10.9
France	15.8	16.7	16.1
United Kingdom	15.4	9.3	14.2
West Germany	15.7	14.6	14.9
Italy	14.4	21.6	22.0
U.S.	10.8	8.0	5.3

1/ Data is 1974-80 annualized for France, Italy and U.S.; 1974-79 for Japan, Germany, Canada and United Kingdom

2/ Data is 1980 for Japan, Italy and Netherlands; three quarters of 1981 annualized for Germany, United Kingdom, and Canada; and two quarters of 1981 annualized for France

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SOURCE: OECD and U.S. Department of Commerce

TABLE 3

INTERNATIONAL COMPARISON OF TAX TREATMENT OF INDIVIDUALS' DIVIDEND & INTEREST INCOME

Country	Dividend: Integration of Corporate-Shareholder Taxation 1/	Dividend: Maximum Marginal Tax Rates	Dividend: Allowances or Exemptions 2/	Interest: Avg. of Maximum Marginal Tax Rates 3/	Interest: Allowances or Exemptions 2/
U.S.	None	50%	$100	50%	None 4/
Australia	None	60	None	60	None
Belgium	Indirect	59	$942	72	$942
Canada	Indirect	27	$829	43	$829
France	Indirect	40	$646	38	$646
Germany	Direct	20	None	56	Certain interest exempt and some incentives
Italy	Direct	47	15% source tax rate	28	10% on certain interest
Japan	Indirect	70	20-35% source tax rate	45	Exempt on $66,900 principal
Netherlands	None	72	None	72	$323
Sweden	None	58	$180	58	$180-$1,015
United Kingdom	Direct	64	None	75	None

Note: Data for foreign countries is as of 12/15/80.

1/ Current tax law in most countries taxes corporate earnings twice, once through corporate taxes and again as dividend income when paid to shareholders. Integration is the tax method of reducing the burden of double taxation usually through reduced taxes to individual shareholders. For purposes of this table; we are defining direct integration as a system where the rate of corporate tax affects the shareholders maximum tax rate and indirect integration as a system where individual shareholder tax rates are reduced by adjustments which are not directly related to the corporate income tax rate.

2/ The amount only of the allowance or exemption is shown, which in some cases may apply to a combination and interest income.

3/ Average of the maximum marginal tax rates on federal government bonds, corporate bonds, savings accounts, and other interest.

4/ A 15% net interest exemption is scheduled to take effect 1/1/85.

of the ten foreign countries studied have designed an integration system to offset this double taxation. Although the U.S. provides a $100 ($200 on joint returns) dividend exclusion, five foreign countries have both integration and much more generous allowances than this. Germany has a direct integration system and a 20 percent maximum marginal tax rate. Japan has indirect integration and a 20 percent to 35 percent at the source tax rate on dividends within certain limits. These two nations enjoy high rates of real investment and savings along with comparatively low rates of inflation.

In terms of individuals' interest income, only the U.S. and two foreign countries do not provide any special allowance or exemption. The net interest exemption as contained in current U.S. law is not effective until 1985.

Overall, in a comparison with foreign nations the tax treatment of dividend and interest income in the U.S. is among the harshest. There is almost universal recognition of the importance of savings and investment. Other nations recognize this in tax measures designed to increase individual savings and investment. In contrast, the U.S. tax code would appear to penalize such behavior.

SAVINGS AND INVESTMENT INCENTIVES ACT OF 1982

The Savings and Investment Incentives Act of 1982 makes several refinements and improvements to current law the 15 percent tax exemption of net interest income effective January 1, 1985. First, the expansion of the exemption and the implementation of the proposal in July 1982 instead of January 1985 will aid economic recovery. Secondly, with the phase-out of the consumer interest deduction, the propcsal aims to correct the marked consumption bias of this country's tax policy. The U.S. is the only industrialized nation whose tax code permits the itemized deduction of consumer interest expense. Finally, the bill establishes tax neutrality among savings alternatives by applying the partial exclusion to dividends as well as an interest income. By increasing the after-tax return of dividends, the bill takes an important step toward increasing the availability of sorely needed equity capital.

HISTORY AND RESULTS OF DOUBLE TAXATION OF DIVIDEND INCOME

Corporate income distributed as dividends has been subject to taxation at both the corporate and shareholder levels since the inception of the individual income tax in 1913. Between 1913 and 1953, the tax on an individual's dividend income escalated from a surtax to full taxation as regular income. In 1954, Congress enacted two measures to mitigate the double taxation on dividends -- a $50 per person dividend exclusion and a 4 percent dividend tax credit. The dividend tax credit was eliminated and the exclusion boosted to $100 in the mid-1960s. In 1980, Congress recognized the devastating effects of inflation on individuals' savings and effected a temporary exclusion per capita of $200 for dividend and interest income for 1981 and

1982. This exclusion was terminated in the 1981 Tax Act and the former $100 exclusion for dividends only reinstated.

Although the corporation and its shareholders are in fact two separate entities, there is only one profit. As the cost of borrowed money, interest payments, is a tax-deductible corporate expense, a bias toward debt financing has been spawned. Historically, of the 52 percent of outlays for plant and equipment in the U.S. raised by debt/equity financing, about 90 percent has been derived from debt financing. (Building a Better Future: Economic Choices for the 1980s, New York Stock Exchange, 12/79.)

This bias toward debt has severely damaged American Industry. Since 1965, the corporate debt/equity ratio has more than doubled. Over the relatively short period of seven years, 1974-81, corporate debt outstanding escalated by almost 100 percent from $601 billion to $1.2 trillion. In times of economic downturn, the disastrous effects on a corporation of a highly leveraged balance sheet are illiquidity and possible bankruptcy. Recently, these potential consequences have become a reality for many of the corporations now filing bankruptcy papers or requesting lenders to defer interest or principal payments.

FUTURE CORPORATE FINANCING NEEDS

The financing needs of corporations have escalated sharply in recent years, as profits have eroded in the wake of inflation, overtaxation, and the outdated depreciation system which Congress replaced last year. The external financing requirements of corporations have soared by almost 150% from $57.7 billion in 1976 to an estimated $142.4 billion in 1982. (1982 Prospects for Financial Markets, Salomon Brothers, Inc.) Over the same period, the ability of corporations to finance growth internally has also increased, but at a far slower pace than external financing needs.

Corporations' over-reliance on debt means that the staggering financing needs of the 1980s must be met largely through equity financing. The equity markets stagnated in 1981 and have shown no improvement in 1982. To promote savings without promoting equity investment is to ignore one of our most vital sources of capital. The Savings and Investment Incentives Act of 1982 treats dividend and interest income alike. The current provision effective in 1985, discriminates against dividend income. Making equity investment as attractive as debt investment in terms of the exemption, should allow corporations to increase that portion of corporate funds raised in the equity markets.

The inclusion of dividend income in the exemption should improve the after-tax return on equity, thereby enticing more individuals to invest in much-needed equity capital. Until the major changes reshaping our economic and financial environment become clearer, business and financial risks will remain high and investors will require the higher returns commensurate with these risks. The skyrocketing costs of equity financing in recent years has far outstripped improvements on return on equity, leading to an accompanying dramatic drop in security prices. Table 4 shows that although the return on equity rose from 12.7 percent in the 1960s to an estimated 15.0 percent in 1981, the cost of equity soared from 10.7 percent to an extraordinary 21.1 percent in the same period. ("What is an Adequate Return on Equity for the 1980s?", U.S. Long-Term Review, Data Resources, Inc., Spring, 1982.) The spread between these two indicators of corporate health was a negative 4.1 percent in 1980 and a negative 6.1 percent in 1981.

The declining spread between the return on equity and cost of equity has paralleled a drop in security prices. The price-earnings ratio for the S&P 500 companies has slipped steadily from 16.1 percent in the 60s, 10.7 percent in the 70s to 8.3 percent in 1980 and a discouraging 7.9 percent in 1981. By 1981, some 40 percent of the stocks on the New York and American Stock Exchanges were selling below book value.

ECONOMETRIC SIMULATION

SIA commissioned Data Resources, Inc., to analyze the Savings and Investment Incentives Act of 1982 through utilization of its well-known model of the U.S. economy. While models cannot precisely forecast the effect of policy changes, they are useful in indicating the direction and relative impact of various policy changes on the economy. Basically, the Savings and Investment

TABLE 4

COMPARISON OF RETURN ON EQUITY, COST OF EQUITY AND PRICE/EARNINGS RATES, 1963-81[1]

Period	Return on Equity	Cost of Equity	P/E Ratio
1963-69	12.7%	10.7%	16.1%
1970-79	13.0	12.5	10.7
1980	14.5	18.6	8.3
1981	15.0	21.1	7.9

SOURCE: Data Resources, Inc.

Incentives Act of 1982 is a relatively small policy change which produces a considerably favorable impact on the economy. Table 5 shows the change induced by the proposal on several key economic variables and on tax revenues.

The proposal would increase real savings by $2.1 billion over the 1982-85 period. Importantly, the increase in savings far outweighs the effect on consumption by a 2.1 ratio. The existing bias toward consumption over savings contributes to the nation's present economic ills. S. 2214 proposal mitigates this bias. Moreover, the proposal boosts real GNP by $1.8 billion.

Personal tax receipts drop off during the first two years the proposal is in effect by $700 million. However, the gain for the two years of $5.5 billion in 1984 and 1985 is impressive and more than offsets the prior years' losses. The gain in tax receipts translates, of course, to a decrease in the federal budget deficit. This proposal reduces the federal deficit by $1.9 billion in 1984 and $3.8 billion in 1985.

CONCLUSION

The need to stimulate savings and investment is emphasized by the deterioration of the economy. The Savings and Investment Incentives Act of 1982 begins to address that need. Current law discriminates against dividend income, supports an over-reliance by corporations on debt, rewards individuals for incurring debt and penalizes savings. Present policy is contrary to that of

TABLE 5

Macroeconomic Impact of the
Savings and Investment Act of 1982

Absolute Change
($ millions)

	1982-85
Real GNP	$1,800
Real Investment	$ 400
Real Savings	$2,116
Real Consumption	$1,000

Revenue Change
($billions, nominal)

	1982	1983	1984	1985
Federal Budget Deficit1/	$(0.4)	$(0.3)	$1.9	$3.8
Personal Tax Receipts	$(0.5)	$(0.2)	$1.9	$3.6

1/ A negative change adds to the deficit and a positive change reduces the deficit.

most industrialized nations, stymies corporations' ability to raise equity capital, discourages individual investors and contributes to the institutionalization of securities markets.

The Savings and Investment Incentives Act of 1982 represents an important, though relatively small policy change which ultimately produces a considerably favorable impact on the economy. Results of the Data Resources Inc. econometric simulation show that the proposal boosts real GNP by $1.8 billion and real savings by $2.1 billion over the 1982-85 period. Importantly, the increase in savings far outweighs the effect on consumption by a 2.1 ratio. Focusing on revenues, the proposal reduces the federal deficit by $1.9 billion in 1984 and $3.8 billion in 1985, more than offsetting the small cost of the prior two years.

Expanding the nation's pool of savings is one step toward remedying the economic ills that have plagued the nation in recent years. Additional savings encourages the increased investment that is desperately needed to improve productivity, lower costs, slow inflation, and ultimately make the U.S. more competitive. The Savings and Investment Incentives Act of 1982 will increase savings and mitigate the debt bias of the tax code. We cannot afford to delay implementing savings incentives nor to ignore equity investment as one of our most vital sources of capital, if the U.S. economy is to regain its vitality.

Senator DANFORTH. I have only one question. Do either of you know of any evidence that dividend or interest exclusions have had on the battle in increasing savings for investment?

Mr. TARTIKOFF. We, of course, have been very interested in this for quite some number of years. We have reviewed all of the economic studies and commissioned one of our own last year with respect to the IRA legislation.

I can't cite you chapter and verse now, but there is a point at which interest and dividend exclusions is so favorable that it does influence such behavior. It is certainly not at the $100-level, but there is a definite point. I would be happy to supply you with that.

Senator DANFORTH. The committee would like to have that.

Mr. TARTIKOFF. I would be more than happy to supply it.

[The following was subsequently supplied to the committee:]

INVESTMENT CO. INSTITUTE,
Washington, D.C., May 28, 1982.

Re S. 2214.

Hon. JOHN DANFORTH,
U.S. Senate, Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR DANFORTH: During my testimony on S. 2214 before the Subcommittee on Taxation and Debt Management and Subcommittee on Savings, Pensions, and Investment Policy, you asked if I had any information which showed at what level dividends and interest exclusions would increase personal savings.

In January 1980, Tax Foundation, Inc. calculated the effect on personal savings of the $200 ($400 on a joint return) exclusion of interest and dividends. They estimated that this exclusion would result in gross private savings of over $2 billion. A copy of their report is enclosed. It would appear as if they over-estimated. However, many persons argue that the $200/$400 exclusion was too small to provide the necessary incentive. An exclusion of $1000/$2000 might provide sufficient incentive, but seems too costly in this era of budget deficits. S. 2214 appears to provide compromise by offering a percentage exclusion for *net* interest and dividend income.

A precedent exists for percentage exclusions which has proven to be successful. In 1978, Congress raised the percentage exclusion on capital gains from 30 percent to 40 percent. The enclosed report prepared by the Securities Industry Association indicates that the increase exclusion for capital gains had an extremely positive effect on new investment.

Please note that my testimony on S. 2214 emphasized that the exclusion from income for dividends should, at the least, be no less favorable than the exclusion for interest received for two reasons. First, the savings incentive for investments in common and preferred stocks that are essential to provide equity capital for American industry should be at least as strong as that available to holders of interest-bearing indebtedness. Second, corporate income distributed as dividends is subject to double taxation (once to the corporation and again to the shareholder) while corporate income used to pay interest is taxed only to the individual recipient. This double taxation of dividend income creates a special need for a favorable adjustment in the federal income tax laws for dividends received by individual shareholders.

I would be pleased to respond to further questions or supply additional information.

Sincerely,

WILLIAM M. TARTIKOFF,
Assistant Counsel.

FEDERAL TAX PROGRAM EVALUATOR

Analysis of Proposed Federal Tax Legislation and Major Programs Affecting the Capital Formation Sector

Office of Tax Policy
Tax Foundation Incorporated
1875 Connecticut Avenue, N.W.
Washington, D.C. 20009

January 25, 1980 Vol. I No. 1

PERSONAL SAVINGS INCENTIVES

In late January the House Ways and Means Committee will hold hearings on tax incentives for personal savings--a subject of gathering interest and numerous bills pending before the Committee. The first Federal Tax Program Evaluator analyzes four distinct approaches to encouraging growth of individual savings as represented by:

1. An interest and increased dividend exclusion (Senate Amendment to H.R. 3919).
2. A tax-free "rollover" for savings (H.R. 5779, S. 1964).
3. A reduction in the top marginal tax rate to 50% (no separate bill).
4. A tax credit for incremental savings (H.R. 169).

* * * * * * * * *

1. Exclusion of Interest and Dividends--Senate floor amendment to H.R. 3919, The Crude Oil Windfall Profits Tax Act of 1979, by Senator Lloyd Bentsen (D-TX). Adopted 94 to 4.

Objective:

To reduce the tax burden on interest and dividend income and to encourage additional savings and investment by individuals.

Description of the Measure:

The amendment permits individual taxpayers to exclude $200 ($400 on a joint return) of interest income and $200 ($400 on a joint return) of dividend income from taxable gross income provided the interest income is received from qualified domestic sources and the dividend income is received from a domestic corporation.

Qualified interest income includes: 1) interest or dividends received on a deposit in a banking or thrift institution that is insured and supervised or regulated by federal or state law or is protected by state law; 2) interest received from financial institutions and financial intermediaries; 3) interest from registered obligations issued by domestic corporations; and 4) taxable interest received from a governmental unit or agency.

Support and Opposition:

Several bills have been introduced providing interest exclusions from $100 all the way to $5,000. Rep. Hensen Moore's separate legislation, H.R. 1429, providing an interest exclusion of $100, has been cosponsored by 54 House members as of late January, 1980. The Treasury has consistently opposed the exclusion of any interest income because of the revenue loss and alleged lack of real increase in savings.

Commentary:

The interest exclusion would be the first such preferential treatment of interest income. Currently, interest income is included entirely as ordinary taxable income. A dividend exclusion, however, does exist at a level of $100 ($200 on a joint return) serving as a nominal offset to the double taxation of dividends. To the extent that the exclusion encourages investment in dividend-producing assets, the increase in the exclusion should provide a marginal incentive to holding such assets.

Although the amendment was offered and adopted by the Senate, the House has also expressed interest and support for such a tax change, particularly the interest exclusion. Most recently, the House Ways and Means Committee reported H.R. 5741, the Mortgage Subsidy Bond and Interest Exclusion Act of 1979, which contains an interest exclusion of $100 ($200 on a joint return). At this writing, the House conferees on the windfall profits tax bill apparently have accepted a $100 interest rate exclusion and thus it is very likely that some form of the Bentsen Amendment will be enacted.

Revenue and Economic Impact:*

TABLE 1. $200/$400 EXCLUSION OF INTEREST AND DIVIDENDS

	1980	1981	1982	1983	1984	1989
Initial Revenue Impact ($ bils.)	(0.9)	(0.9)	(1.3)	(1.4)	(1.5)	(2.7)
Economic Impact ($ amounts in bils.)						
Increase or Decrease (-) in:						
Gross Private Saving						
(current $)	2.3	4.6	6.1	8.2	11.1	8.5
(1979 $)	2.1	3.9	4.8	6.0	7.5	4.1
GNP (1979 $)	2.2	2.8	3.5	4.2	5.4	7.4
Private Investment (1979 $)	1.4	3.1	3.9	5.0	6.6	3.4
Consumption (1979 $)	0.8	(0.3)	(0.4)	(0.8)	(1.2)	4.0
Employment (000)	17	22	26	30	39	47
Net Federal Revenues						
(current $)	(0.8)	(0.9)	(1.1)	(1.4)	(1.3)	(1.5)
(1979 $)	(0.7)	(0.8)	(0.9)	(1.0)	(0.9)	(0.7)
Change in Gross Private Saving Per $ of Initial Revenue Loss	2.56	5.11	4.69	5.86	7.40	3.15
Change in Gross Private Saving Per $ of Net Revenue Loss	2.88	5.11	5.55	5.86	8.54	5.67

Source: Institute for Research on the Economics of Taxation (IRET).
*See Appendix for explanatory notes.

Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Volume V No. 8 December 17, 1979

REMOVING TAX DISINCENTIVES DOES WORK

HIGHLIGHTS

1. There is strong evidence that the capital gains tax cut passed in late 1978 has been effective in stimulating certain sectors of the economy.

2. The performance of the stock market in 1979 has been in line with projections made last year about the impact of a capital gains tax cut despite generally more dismal economic and international developments than were foreseen.

3. In an Opinion Research Corporation survey of over 500 top and middle managers, one-quarter reported making new or increasing existing investments as a result of the reduction in the capital gains tax cut.

4. The sample respondents favored increasing investments in common stocks over other alternative investment vehicles.

5. Other indicators of the beneficial impact of the capital gains tax cut are: relatively higher price appreciation for the stocks of smaller capitalized companies; an increase in the amount of equity capital raised by smaller companies; and a marked pickup in venture capital investments.

6. Recently, the Senate Finance Committee approved a bill relieving the tax burden on interest and dividend income slightly. Such a bill is consistent with tax measures adopted recently by other nations to spur productivity, employment and competitiveness in world markets.

Securities Industry Association
New York, N.Y. 10005 • (212) 425-2700

Introduction

The Revenue Act of 1978, passed last October, produced the first capital gains tax cut in over 40 years. Proponents had argued that the measure would encourage investment and capital formation. But, within the first few months of its passage, attempts were made to discredit the measure based on a lackluster stock market. More recently, former Secretary of the Treasury Blumenthal was quoted as saying that the capital gains tax cut did not lead to the benefits projected by supporters and a recent New York Times editorial supported this viewpoint. In all fairness, the Times article acknowledged that no specific tax policy can work in isolation.1/ Actually, there is strong evidence indicating that the capital gains tax cut has been highly effective in stimulating certain sectors of the economy.

This paper builds on a recent article in the Wall Street Journal which supported last year's reduction in the capital gains tax.2/ It incorporates new data demonstrating that lowering the capital gains tax did lead to specific benefits for the economy.

As the debate over our tax structure continues, questions about the efficiency of the capital gains tax cut are likely to reappear. This debate is likely to intensify during the upcoming Presidential primaries and campaign. Therefore, it is essential that the most comprehensive evidence about the effects of the capital gains tax cut be presented and analyzed.

Comments on the Views of the Critics

The concern about the relationship between the capital gains tax cut and monetary policy was noted by SIA in its comprehensive study of tax policy, investment and economic growth. Two sets of statistical tables were presented for each of the nine tax proposals analyzed in that study.3/ The first set assumed accommodating

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1/ See the New York Times, "Capital-Gains Tax Cut to Nowhere," December 4, 1979, p. A26. The Times noted that the tax cut on capital gains might have worked if there had not been deliberate government policies aimed at increasing the cost of money and slowing down economic growth.

2/ See Edward I. O'Brien, "Reduction of Tax on Capital Gains Spurs Investment," Wall Street Journal, October 31, 1979.

3/ See Securities Industry Association, Tax Policy, Investment and Economic Growth, Chapter [illegible] and [illegible], March 1979.

monetary policy while the second set assumed non-accommodating monetary policy. Needless to say, the projected economic results from any of the tax cut proposals under non-accommodating monetary policy were quite modest and considerably less than that projected under the assumption of accommodating monetary policy. This fact is conveniently overlooked by most critics of the capital gains tax cut.

Another point glossed over by some critics concerns the argument that the stock market has not lived up to the expectations of proponents of the capital gains tax cut. Actually, there were wide discrepancies in the predictions by the three organizations which were most active in developing projections concerning the likely impact of a capital gains tax cut upon the S&P 500 Index's performance. The most optimistic forecast was that of Chase Econometrics Associates, which projected that the S&P Index would appreciate about 40% over its level without such a reduction by 1982.4/ Merrill Lynch Economics, Inc. forecasted a much more modest increase -- 4% - 6%,5/ while SIA predicted an increase of 10%. Readers may be surprised to learn that from November 30, 1978 to November 30, 1979, the S&P 500 Index increased 12.1% despite considerably higher inflation and interest rates and generally more dismal economic and international developments than those predicted by almost all forecasts last year. So the criticism that the stock market has not responded as anticipated by supporters of the capital gains tax cut has not been factual.

Investors Increased Their Investment Because of Lower Capital Gains Tax

Earlier this year, SIA commissioned Opinion Research Corporation (ORC) to undertake a survey of reactions by investors to [illegible] different tax proposals. Although any tax proposal aimed at increasing savings and investment should appeal to all income groups, it is acknowledged that most such additional savings will come from those with higher earnings. Thus, SIA, in consultation with ORC, agreed to utilize ORC's quarterly Executive Caravan Survey, which is a sample of over 500 top and middle managers in the Fortune 800 companies. The October survey was used to evaluate responses to five alternative tax proposals, as well as other questions. One key question was: As a result of the changes in the capital gains tax law, did you make new investments, or increase existing investments during 1979?

4/ [illegible]

5/ Merrill Lynch Economics, Inc., "Economic Impact Analysis of a Capital Gains Tax Reduction," August 22, 1978, p. 4.

The Executive Caravan sample represents a group of individuals particularly knowledgeable on tax regulations and investment alternatives. By understanding the attitudes and preferences of executives and managers, it should be possible to make judgments about the efficacy of alternative tax proposals as well as the capital gains tax cut last year. SIA plans on publishing and distributing the findings from the ORC survey early next year.

Preliminary Survey Results

The survey revealed that almost one-quarter of the sample reported making new or increasing existing investments as a result of the reduction in the capital gains tax. In addition, the respondents favored investment in common stocks over the other investment alternatives available for selection. The findings indicate that 15% of the respondents increased their purchases of common stock compared to 11% investing in real estate, the second highest category for new or increased investment.6/

The survey results also allow for an analysis of how different income groups responded to the capital gains tax cut. Table I classifies the data according to the respondents' incomes. A significant finding is that all of the income groups reported making new or increasing existing investments in response to the change in the capital gains tax law. The proportions ranged from 10% of those respondents with earnings under $30,000 to 36% of the individuals receiving more than $75,000.

The table also shows that investments in real estate were favored over common stocks by respondents with incomes lower than $30,000. But for each income category above $30,000, the proportion of the respondents making new or additional investments in common stocks was larger than for real estate as well as any other investment alternative. Evidently, given the proper incentive, common stocks are very desirable to those with funds to invest.

6/ The other categories of investment and the proportion of the Executive Caravan increasing investments in these categories were: mutual funds and [illegible] -- [illegible]; corporate bonds -- [illegible]; futures trading -- [illegible]; [illegible] -- [illegible]; tax shelters -- 4%.

Table I

THE RESPONSE TO THE REDUCTION IN CAPITAL GAINS TAXES BY INCOME GROUP

	Income				
	Under $30,000	$30,000-$39,999	$40,000-$49,999	$50,000-$74,999	$75,000 or Over
Percent of respondents who made new or increased existing investments as a result of the capital gains tax cut	10%	22%	18%	28%	36%
As a result of the changes in the capital gains tax, the percent of respondents who invested in:					
Common Stock	0%	12%	12%	17%	25%
Common Stock Mutual Funds and Preferred Stock	2	4	2	3	3
Corporate Bonds	0	1	0	0	2
Futures/Options	2	0	1	1	4
Real Estate	8	5	0	12	15
Tangible Investment	0	2	0	1	2
Tax Shelter	0	0	0	0	2
Unknown	0	0	1	0	1

Another variable used in the analysis was the relationship between additional investment and the value of the securities holdings of the respondents. The data disclosed that of the respondents with securities holdings of less than $25,000, 8% made new or increased existing investments in common stock; 16% of those with securities portfolios between $25,000 and $49,999 raised the level of their investments in common stock; and 25% of the executives with securities holdings of more than $100,000 put additional funds into the stock market. Clearly, the capital gains tax cut influenced many of the respondents to add to their securities holdings and the measure had a more substantial impact on those with larger portfolios. The magnitude of those increasing their stock and other investments is impressive in light of the economic, political and international uncertainties which were so evident.

Other Indicators

[illegible] as new venture capital enterprises. There are three principal early indicators of the effects of capital gains tax cuts: relatively sharper price appreciation for the stocks of smaller-capitalized companies; an increase in the amount of equity capital being raised by companies of all size as well as smaller corporations; and a marked pickup in venture capital investments.

Differences in Price Appreciation

The U.S. stock market offers a broad range of investment opportunities, each associated with a different level of risk and rate of return, ranging from heavily-capitalized issues represented by the Dow Jones Industrial Average and the S&P 500 Composite Index to smaller-capitalized issues represented by the American Stock Exchange Index (AMEX) and the NASDAQ Index. The smaller-capitalized issues are relatively more risky than the larger-capitalized stocks and presumably offer potentially higher returns. Institutional holdings, many of which are exempt from all taxes on income and capital, are predominantly in the larger-capitalized issues while individual investors have tended to invest in the smaller-capitalized stocks. Thus, any reduction in capital gains taxes which applies primarily to individuals should impact upon these two kinds of issues differently.

This is exactly what has happened, as can be seen by the strikingly different rates of appreciation of the indices representing larger and smaller-capitalized companies. From October 31, 1978 (when parts of the revised tax code were scheduled to become effective), to November 30, 1979, the Dow Jones Industrial Average rose only 3.8% and the S&P 500 14.0%; in contrast, the American Stock Exchange Index increased 66.6% and the NASDAQ Index rose 29.8%. Apparently, individual investors valued the stocks of smaller-capitalized and presumably higher profit-potential companies at substantially higher prices since the reduction in capital gains taxes.

Stock Offerings Are Up

Initial public offerings of common stock enable less known companies to raise equity capital. In attempting to measure the impact of tax policies on the level of new issues, there are other economic variables which must be taken into account. The overall stock market climate, which is influenced by many economic and political variables, is probably the most important influence on the level of initial public offerings. In spite of these factors, however, the impact of the tax policy change is clearly visible.

The volume of initial public offerings of common stock in [illegible] was higher than any year since [illegible] (see Table II). It is [illegible] tial public offerings to be about double the level of recent years.

Table II

COMMON STOCK INITIAL PUBLIC OFFERINGS
1968 Through First Half 1979

Year	Share Value ($Millions)	Number of Issues
First Half 1979	$ 256	59
Second Half 1978	160	40
First Half 1978	54	18
1977	276	49
1976	271	45
1975	236	25
1974	117	55
1973	1,872	177
1972	3,301	646
1971	1,917	446
1970	1,451	566
1969	3,545	1,298
1968	1,742	649

Source: Investment Dealers' Digest

As shown below, the amount of equity capital being raised by companies with a net worth of under $5 million is also higher than in most recent years (see Table III). The value of equity issues for the first half of 1979 is keeping pace with 1978 and has already surpassed the annual totals for 1974, 1975 and 1977. Furthermore, all but $1.2 million of the $129 million of equity capital raised in 1978 was raised in the second half of the year. This surge in offerings during the second half of 1978 was even more pronounced than the figures for initial public offerings covering companies of all sizes.

Table III

EQUITY CAPITAL RAISED BY COMPANIES
HAVING A NET WORTH OF UNDER $5 MILLION

Year	Share Value ($Millions)	Number of Issues
First Half 1979	$ 55.9	16
Second Half 1978	128.1	20
First Half 1978	1.2	1
1977	[illegible]	[illegible]
1976	[illegible]	29
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
1970	375.0	198
1969	1,366.9	698

Source: Venture Capital Inc.

Thus, while tax policy is only one of many factors determining the receptivity of investors to new issues, it does play a major role in creating a favorable or unfavorable environment for new equity offerings.

Venture Capital

Finally, there has been a sharp increase in the amount of funds committed to venture capital enterprises, many of which are in the form of privately negotiated arrangements to find or buy into existing small companies that have not yet gone public. Stanley Pratt, editor of the Venture Capital Journal, estimates that private partnership venture capital investments amounted to approximately $22.5 million in 1974. No private funds were committed to venture capital enterprises during 1975. In 1976, such funds amounted to $25.7 million and in 1977, just $20.2 million was raised. In 1978, private partnership venture capital investments rose dramatically, to $215 million. The bulk of this increase took place in the fourth quarter of 1978, when Congressional passage of the capital gains tax cut was imminent. As reported in the Wall Street Journal, it is believed that the amount of funds allocated to venture capital investments will reach close to $300 million in 1979.7/

Thus, responses from ORC's Executive Caravan, the market indices, new stock issues and venture capital commitments add up to solid evidence that the 1978 capital gains tax reduction has had a positive impact on investment, despite other very negative developments in the U.S. economy. More important, from a public policy viewpoint, the main beneficiaries of the lower capital gains taxes appear to be smaller companies. It is increasingly recognized that just such young, innovative companies are responsible for the greatest percentage gains in employment and technological advances.

The Pendulum Is Changing

More and more policymakers are voicing concern over the critical problems of high inflation and lagging productivity in this nation. Demands are being made for greater fiscal discipline by the government in striving to reach a balanced budget. Policymakers are concerned over individual behavior which resembles a race to consume rather than save and invest. To encourage additional savings and investment, various tax proposals are being

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7/ See [illegible]

discussed. Just recently, the Senate Finance Committee approved a bill which would increase the dividend exclusion from $100 for a single taxpayer and $200 for a joint return to $200 and $400, respectively. At the same time, interest receipts would also be eligible for this exclusion from income taxation.

Other nations have adopted tax measures aimed at promoting savings and capital formation to spur productivity, employment and competitiveness in world markets. The French Government, in particular, has developed a series of incentives along this line.8/

The emerging "gut" feeling of policymakers in this country and elsewhere that current tax policies impede savings and capital formation is also supported by the work of academicians. A path-breaking study published by Professor Michael Boskin concluded that policies which raise the after-tax return to capital will increase national income, eliminate an economic loss to society resulting from distortions of the consumption/saving choice and actually redistribute income from capital to labor.9/ Boskin found a positive relationship between savings and the real rate of return on capital. Thus, current tax policies on the returns from capital cause a decrease in savings and investment and a reallocation of consumption from the future to the present. A shift in tax policies away from taxes on capital or personal income to other tax bases will increase savings, capital investment relative to labor input, national income and eventually redistribute more of a larger pie to labor from capital.10/

Conclusion

The debate over Federal tax policy will likely command a great deal of attention from the Congress and Administration during 1980. The emerging evidence indicates that proponents of lower taxes on savings and investment should adopt an aggressive rather than defensive stance. The results of last year's capital gains tax cut are impressive, particularly in light of a very unfavorable macroeconomic environment. Any comparison of tax policies between the U.S. and other major industrialized nations concerning capital gains, interest and dividend income would reveal the U.S. tax treatment as relatively severe. Additional initiatives are required to reverse this country's lagging capital investment and to encourage savings and capital formation.

Jeffrey M. Schaefer
Vice President and
Director of Research

8/ For a full discussion of the comprehensive program adopted by the French Government to encourage capital formation, see Rolf E. Wubbels, "The French Economic Miracle: What a Differ-ence Leadership Makes," Financial Analysts Journal, July/August 1979, pp. 23-27.

9/ [illegible] Boskin, "Taxation, [illegible] and the Rate of Inter-est," [illegible]

10/ Ibid., p. [illegible].

Mr. O'BRIEN. Senator, at this point the amount is simply too low to be very attractive. Increasing it would clearly be an incentive if done equitably between dividends and interest.

Senator DANFORTH. It is my impression that it has not been a terribly efficient way of encouraging savings. Obviously we all want to encourage savings, the question is how to do it with the most propitious use of preparatory resources.

Mr. O'BRIEN. Yes.

Senator DANFORTH. Thank you for appearing.

Mr. TARTIKOFF. Thank you, sir.

Mr. O'BRIEN. Thank you.

Senator DANFORTH. Now we will proceed to S. 2281, and a panel consisting of Mr. David Fish and Mr. Steven Jobs.

Mr. Fish, would you proceed?

STATEMENT OF H. DAVID FISH, SPECIAL PROJECTS DIRECTOR, SAN DIEGO CITY SCHOOLS, SAN DIEGO, CALIF.

Mr. FISH. Mr. Chairman, members of the committee, ladies and gentlemen, we are in a unique situation this morning because, in the normal pattern, witnesses of our type are heard and then the administration responds. In consideration of the time, I would like to restrict my comments to answering some of the concerns and to put them into context.

I am from San Diego, Calif.—the San Diego City schools—in a district of 110,000 students, the 14th largest in the country, 2d largest in California.

In response to this legislation, we are vitally concerned about it and support it very strongly. The reasons we consider it important in educational terms are given in my written testimony. We believe that the microcomputer, based on work that we have done, presents us with an opportunity to finally join the 20th century. Educational innovation in this country has not been effective. All of the various other great developments—television, movies, and all the others—have never made the impact that the microcomputer promises to make.

I am very concerned that people understand that this innovation gives us a chance to get away from the classroom with 1 teacher and 30 students. It gives us a chance to meet the needs of individual students.

This morning we heard about the fact that under current law contributions can be made to medical institutions, for remedial purposes, I believe it was. I have actually seen deaf children utilizing the microcomputer, being able to learn much more, much faster, much better than they ever have before.

We believe that the proposed legislation provides a great incentive by putting computers in all schools. We frankly have already benefited from computers, but we are aware that this is a technology that is with us right now, is in Senate offices right now, and permeates our society.

To switch this morning's discussion slightly, there was one concern I did have, and that was the use of the word "charity" in regard to this bill. This is not charity. I am not representing a charitable institution. In some measures and some programs that we carry out such as school lunch, the schools are utilized to deliver services to certain people who need it; but we are an educational institution. We are an investment for this country's future. What we are doing now is desperately attempting to catch up with a technological gap that could haunt us forever.

I would say that this investment can't be deferred. To give you an idea of the difference between the past and the present reality, probably most of the people in this room, when they were in school, learned about slide rules. Slide rules aren't even manufactured anymore. The new learning devices are the computer and the technology that the schools do not have.

Now, schools are caught in a very tough situation. We must increase productivity. Work being carried on by our school district and others makes us believe that we are going in the right direction. I will not go into proving that point because of time.

We must produce people who are familiar with and can utilize the technology that dominates our society. We must have educational institutions that have the equipment that the students will see when they go out for jobs.

If you look in papers like the Los Angeles Times you will see row upon row of advertisements for people who have the skills in programing and in other aspects of computer operation. We, of course, are interested in the instructional application of the computer for all students. We would like to do more research and development, but we do not have the money. Less than one-half of 1 percent of all education expenditure is in these areas. We don't have money for running the risk of applying the technology. If we can get assistance—and we've been told to go to the private sector—we will gladly take it. We have here a bill that would enable companies to give a third of their profits to the improvement of our society through the schools. We believe we are carrying out that mandate by encouraging this legislation.

We know we can use it; we know it's valuable; we believe it is not even discretionary—it's necessary.

Thank you very much.

Senator DANFORTH. Mr. Jobs?

STATEMENT OF STEVEN JOBS, CHAIRMAN, BOARD OF DIRECTORS, APPLE COMPUTER, INC., CUPERTINO, CALIF.

Mr. JOBS. First I would like to thank you for inviting us here and to introduce Eric Fox. Eric is a partner in our law firm here in Washington and is helping us try to do a reasonable job on this.

First I would like to talk a little bit about what we are trying to do and who this is going to effect, and then move rapidly to respond to Mr. Chapoton's testimony, and provide a different perspective.

We are talking about putting a large quantity of small computers into our schools where they will be used by millions of kids. The main reasons for doing this fall into two broad categories: one is the post-Sputnik crisis situation we are now facing, and the other involves the basic liberal arts literacy requirements.

A little bit of background. You have all heard about the information revolution, or the computer revolution. Time has just added a computer section to its magazine. There have been articles everywhere.

The computer is the epicenter of this information revolution. It was invented in America 36 years ago, and is the reason that a lot of this is happening.

Up until the 1930's the No. 1 occupation in America was a farmer; then in the late-1930's it shifted to a laborer as a result of the industrial revolution. In 1979 it shifted to a clerk—a knowledge worker. This is one of the milestones along the way, that we are really entering the next revolution, which is a knowledge, information-based revolution.

When we talk about improving productivity in America, we normally think of another robot for General Motors; but, indeed, if the No. 1 occupation is a knowledge worker, these types of capital investments in robots are not really what is necessary to fuel major productivity increases. Most of the tools that are increasing productivity are now becoming computer-based. There were approximately 2 million computers shipped this year alone.

Now some of the post-Sputnik reasons:

Information activities now contribute a larger share of the GNP than manufacturing and agriculture combined.

Seventy-five percent of the U.S. work force falls into the service sector.

About two-thirds of the service sector is concerned with information.

The Department of Labor forecasts that the computer industry will be the fastest-growing segment of our economy in the 1980's.

Just some statistics: In California, with which I am a little more familiar, elementary school students average only 45 minutes a week studying science. Only one-third of the Nation's high schools offer more than 1 year of math or science. Only 15 percent of the male and 7 percent of the female students in California take 3 more years of high school science. Achievement scores have been declining since the early 1960's. The number of electrical engineering graduates in the United States has remained constant for the last 10 years despite the explosion in the electronics industries.

The United States has dropped to fourth in scientific literacy, behind Russia, Germany, and Japan. Russia is graduating three times as many engineers as America is. Japan is graduating more engineers than we are, yet their population is half that of the United States.

The AEA, the American Electronics Association, estimates that by 1985 there is going to be a deficit of over 100,000 engineers.

In order to realize the promise of this technical revolution that we are embarked upon and to remain competitive in world markets, this trend has got to be reversed, and it has got to be reversed fast. As a matter of fact, Congress felt so strongly about this that last year it enacted a law which allows the liberalized deductions for contributions of scientific and computer equipment to universities. What we are asking is to extend that liberalized deduction privilege down to all levels of schools.

The second perspective is of a liberal arts nature. Business Week has estimated that there could be as many as 45 million Americans in the next 20 years who are going to be out of their current jobs and need to get retrained. But, probably as important as that, there is a whole generation of kids growing up right now, and most of them are not getting the benefits of the technology that exists today. They are not getting the training that will be necessary for the jobs which will be available when they get out of school.

Probably even more significant, the impact is greatest in the poorer school districts where the budget constraints have been most severely felt. Some of the more astounding examples of where computers have been used in addition to San Diego is the State of Minnesota. There are over 4,000 computers used in the State of Minnesota, and they have a computer-literacy requirement for every graduate of high school.

The key point here is that for every school that has microcomputer equipment there are many that don't, and in particular more of the economically-disadvantaged schools.

We are really talking about investing in human capital on a fairly broad scale.

I would like to address a few points of Mr. Chapoton's testimony.

First, I would like to stress that the Government alone would not be funding this program. It really represents, I think, a partnership between the public and the private sector, as has been talked about by the President and everyone else these days.

Apple has done several studies on the impact to our P and L of this program, and we feel that our implementation of this program will cost us over $12 million. That is approximately 20 cents per share. We anticipate earning approximately a dollar per share this year, and that represents 20 percent of our 1982 after tax profits that we are willing to invest in this program. That mostly is made up of the indirect costs and the percentage of the direct costs that we will not recover.

Senator DANFORTH. Go ahead and make your points, Mr. Jobs. Mr. Chapoton had a long period of time, so you can go ahead and make your points.

Mr. JOBS. Thanks.

His next point is the bill that as drafted will potentially not keep manufacturers from placing computers in the most economically favorable school districts. We have recognized that and are suggesting that there be a one-computer system per school per manufacturer limitation, which would encourage the manufacturers to distribute the computers in a more geographically equitable and demographically equitable fashion.

The next point he makes is that we might not be able to determine fair market value if the donated product is not selling well in the current economic climate. I would just like to point out that this year alone Apple will ship over a third of a million computers, Tandy will ship over a third of a million computers, and, IBM, according to industry estimates, will ship upwards of 200,000 computers. I think that the free market is clearly providing the necessary market value information. Apple will ship over half a million computers next year, whereas there are approximately 103,000 schools in the United States. I think the free market information will be available to provide us the information we need to determine fair-market value.

Another point Mr. Chapoton makes is that raising the charitable contribution limit from 10 percent to 30 percent is some sort of a windfall for industry. We could leave the charitable contribution at 10 percent and take 3 years to get these computers into schools. The net cost in revenue would be, I would assume, approximately equal. The real losers in this case would be the kids, because some of them are going to have to wait 3 years to get the computers. Most computer companies do not use anywhere near their current 10-percent charitable contribution deduction. It's not that we need more of a deduction, but we would like to get the computers into the schools as fast as possible.

One of Mr. Chapoton's last points is that this bill is likely to benefit only a very few taxpayers. The way we see it is quite different. We see that many taxpayers have kids growing up in the schools, and I think we have a responsibility to educate these kids with the tools that they are going to need to get jobs when they leave school.

We feel that this bill does represent a partnership between the public and the private sector. I feel that our industry, Apple as well, is really willing to put our money where our idealism is. We urge you to enact this legislation into law.

Thank you.

Senator DANFORTH. Thank you very much.

[The prepared statements of the previous panel follow:]

STATEMENT ON BEHALF OF THE SAN DIEGO UNIFIED SCHOOL DISTRICT BY DR. H. DAVID FISH, DIRECTOR, SPECIAL PROJECTS, SAN DIEGO UNIFIED SCHOOL DISTRICT

Mr. Chairman, members of the committee, ladies and gentleman, I appreciate this opportunity to come before you today to testify on S. 2281. This proposed legislation, if enacted, will enhance the education of American students, and will make a valuable contribution to our country's technological progress. The stimulation of the introduction and utilization of computers and other technological equipment in our elementary and secondary schools is absolutely essential for improving our productivity, both in the educational system and in the increasingly competitive world of science and technology. The Wall Street Journal reported last August that France already has made "a national commitment to put computers in high school . . ." For American schools, the proposed legislation is crucial to maintaining our current competitive edge.

I speak to you today as a representative of the San Diego Unified School District with 110,000 students, the second largest school district in California. The San Diego schools educate students from all of the groups and classifications of people that constitute our society. From recently arrived Indochinese refugees who speak no English and have had no previous education, to national merit scholars, our school system is serving them all and our test results show substantial success. It is our desire to improve the educational program of our students and to prepare them for the rapidly changing world they face that makes us strongly endorse this legislation. As adults in the educational field, we are encountering an expanding generation gap between our educational program and what is happening in technology, science and business. Our students must know how to use computers and other technological devices that many of us, as educators, are struggling to understand. Yet, we must effectively implement the computer in elementary and secondary programs, both to improve instruction and to enable students to acquire the ability to handle the technology that will dominate their future.

The value of computers in schools to enable students to develop knowledge and skills in the field of computer technology is so great and so necessary that there is not much reason to repeat the obvious. But the use of the computer in the instructional program is even more important for the general improvement of all instruction.

Recent history of education shows that the potential of other major technological developments has never been realized in the classroom, as eduction has not been significantly improved by the innovations of the last 75 years. Radio, movies, television, tape recorders and other technological advances have not substantially changed the instructional program or improved results. However, our experience with the previous innovations and their limited value in education convinces us that the computer does represent a breakthrough. Our work with computers and computer-assisted instruction already gives promise of finally accomplishing the large-scale improvements in productivity that are necessary for education to perform the job that must be done.

Our experience with innovation has identified three phases of development in the schools that must be accomplished if the innovation is to be effectively utilized as an instructional tool in the basic instructional program:

1. Awareness and Exploration. At this stage the schools may have just become aware of the technological innovation itself, and the study of the innovation is sometimes more significant than any actual work accomplished with the tool. The students benefit from learning how the hardware works and become familiar with the terminology and operation in applications that are mainly directed at understanding the potential of the equipment. Many students continue and develop careers in the technology of the innovation as a result of this first type of contact.

2. Experimentation with Utilization in Supplemental Educational Activities. During this stage the equipment is tested doing specifically limited educational tasks and the users develop relatively small scale programs that are supplemental to the basic instructional program. These activities quite often meet the needs of students for limited purposes, such as drill or remedial exercises. Innovations also are used for enrichment activities where students have developed an interest in working with the technology. Students will utilize the equipment to learn how to use the technology or make a presentation for a special event, such as using equipment to screen an instructional television program.

3. Classroom Implementation in the Basic Program. Very few innovations have succeeded to the point that the teacher considers the technology essential to teaching a class in a basic skills area such as mathematics, reading, or language. Yet, innovations that are applications of technology to instruction must be evaluated as tools in the learning process. None of the previous innovations have has all of the necessary ingredients to be an effective classroom tool for a sustained period. The result has been that the basic pattern of education has not changed in this country since the graded classroom with one teacher and approximately 30 students was first introduced. Almost all programs to improve instruction, either federal or state, have been designed to provide better activities, greater flexibility, or more resources for this basic educational organization. Through all this time, the teachers' primary tools have remained the chalkboard and textbooks. In comparison, during the same period, American agriculture has been mechanized and has benefitted from the scientific developments that have created incrediblie gains in productivity per farmer while improving the quality of the product.

Our experience in San Diego has shown that the proposed legislation will make an important contribution in each of the three phases. Almost all of our schools are already at the Awareness and Exploration stage with mcirocomputers. News reports indicate that awareness is occurring throughout the society. In schools we need to increase awareness of the computer as an instructional tool. Administrators and teachers from many school districts report that not a single computer is available for teachers and students in the entire district to work with. These districts also are not aware of the wide variety of educational programs and activities now becoming available. Despite the impression created by news stories, most schools have not had a systematic introduction to classroom computer utilization.

In our work with improved instruction, we have learned that if students and teachers have not had an opportunity to know and understand the innovation before wide-scale utilization, then the introduction of the innovation will be more difficult. We, therefore, urge that all schools be given the opportunity to become aware of and understand the computer. However, we in education do not have the resources to conduct broad-scale distribution of hardware that has not already been adopted as part of the basic program. I also want to point out that home computers are beyond the means of most families. Although computer literacy is becoming an essential literacy for achievement in our society, the only opportunity for the disadvantage student to work with computers will be in school programs.

In the second stage of implementation, we have developed several supplemental microcomputer programs that meet limited instructional objectives. The most dramatic use has been with deaf students where the patient computer has provided additional drill these students require. This drill can be individualized for each student. The computer also provides visually interaction which has been proven effective in teaching the visually-oriented deaf student. On a broader scale, students are utilizing microcomputers in our schools in a supplemental or remedial mathematics program. A number of students have fallen behind in those areas of mathematics defined as basic competencies everyone needs in our society. Since passing tests in the basic competencies is a graduation requirement, both motivation and a list of specific skills to be mastered provided the stimulus for developing a high-quality microcomputer program teaching 200 objectives in mathematics. In other words, if a student has not accomplished the required level of achievement in certain mathematical areas, then this program, developed and tested and now being used in our school system in pilot classrooms, can give both instruction and drill in the areas of the student's deficiencies. The materials developed for our program are being increasingly requested by schools that are getting their initial computers and that now need programs to supplement their basic instructional program.

The third phase, classroom application of the microcomputer in basic skills instruction, is the most important. Indeed, the computer will revolutionize American education by becoming an essential tool in the main instructional program. The other innovations that have been introduced up to this time failed to really make a difference because the emphasis has been on the presentation of materials to students. Effective education is not simply presentations of content. Real learning only occurs with the active involvement of the student. The greatest movie is complete failure if the student falls asleep, and all people in public life realize that the speech being given may not be the speech the listener hears. The microcomputer has been proven in the work that we have performed because it has several capabilities that previous technologies did not have:

1. The microcomputer is capable of giving the student a one-on-one learning experience that requires student involvement. As the student responds to the computer's questions, the computer can immediately respond with praise and move on to new directions in learning, or respond with correction and review.

2. The microcomputer can be programmed to provide pacing appropriate to the learning situation. On one hand, it can allow the student to work at the student's own pace. At other times it can be directed to require that the student respond within a given time limit.

3. The microcomputer is capable of providing a learning sequence that progresses through the lesson in a linear fashion or in a manner that branches in response to the student's answers.

4. The computer is capable of providing information or instruction beyond the level of the traditional classroom teacher.

5. The computer can provide tireless drill and practice in those areas of education that require it.

6. The computer provides a nonthreatening environment for the learner. Students seem to be able to take correction from the computer more easily than they can from parents, teachers or peers.

The list above is, intentionally, only a partial compilation of the unique characteristics of the microcomputer that make it a valuable educational tool. But the list also illustrates the importance of my final point. Education today has reached the stage where we are developing educational programs that are ready for the computer. The greatest contribution of the computer may be the reform of curriculum through the discipline of more logical and sequential structure.

The San Diego Unified School District is implementing structured basic skills programs in reading and mathematics and expanding the effort into all grade levels. The foundation of our program is the research of Benjamin Bloom of the University of Chicago in mastery learning. Bloom's basic thesis is that learning can be accomplished in small progressive increments. All students can learn if instruction does not proceed beyond the individual's mastery of the prior objectives. Our mastery learning reading and mathematics programs in minority isolated schools have achieved outstanding success. Using computer programs in this educational framework, the teacher will be able to serve more students, provide the students with more opportunities for learning, and improve results.

When we complete the mastery program by incorporating the computer, we will prove that the computer can improve American education by bringing modern technology into the classroom. As the computer and appropriate software is developed, we know that several changes will occur.

1. More students will be actively involved in learning for a longer time, with a corresponding improvement in performance and student satisfaction with education.

2. Instruction will be better organized with greater opportunities for practice and drill, and fewer students will fall behind.

3. The teacher will have additional time to enrich the curriculum and to respond to individual students.

4. While the cost of education will probably not be reduced immediately, more learning will result for the money spent.

Other less obvious and unforeseen changes will undoubtedly occur.

In testimony today we do not want to say that the process of implementing change is ever easy; but, at last we have an innovation that holds great promise to finally let education join the 20th century. We urge this committee to provide the incentive to business to help us move forward for our national interest.

STATEMENT OF

STEVEN P. JOBS

CHAIRMAN OF THE BOARD, APPLE COMPUTER, INC.

BEFORE THE

COMMITTEE ON FINANCE, UNITED STATES SENATE

ON S. 2281

THE TECHNOLOGY EDUCATION ACT OF 1982

May 7, 1982

We are now in the midst of a revolution that is of the same magnitude and power as the industrial revolution of the 19th Century. It is changing our society, our skills and the character of employment in the United States.

This revolution is driven by advances in microelectronics, transforming the contemporary world from an industrial to an information society. At its heart is the electronic computer -- invented in America 36 years ago and destined to become as essential and pervasive a tool in the 1980s as the calculator became in the 1970s.

To maintain America's technological leadership, we must begin training students -- from the elementary through the secondary grades -- in today's computer technology. If we do not, we risk producing a generation of Americans who will be unfit for the jobs that will be available five to ten years from now and who will be both non-competitive and non-literate in the information society now evolving.

The trends are clear. Information activities contribute a larger share of the Gross National Product than manufacturing and agriculture combined. About 75 percent of the U.S. work force falls in the service sector and about two-thirds of the service sector is concerned with information. In short, approximately 50 percent of the work force and GNP are now linked to the information industries.

The Department of Labor forecasts that the computer industry will be the fastest growing segment of our economy in the 1980s. Computer-related jobs dominate five of the six categories of employment which are expected to expand most rapidly in this decade. While the need for scientists will be great, the most pressing requirement will be for "knowledge workers" -- engineering technicians, professionals, managers, clerks and all those who apply computer-communications knowledge in business, industry and government.

Although we are in the formative stage of the information revolution, we can predict the skills that an individual will need to succeed. Computer literacy will become a prerequisite for employment in numerous jobs. Employees in general will require more technological awareness than their counterparts today. Yet, little is being done today to prepare these future employees for the coming work environment.

The state of technological education in the United States is disturbing:

In California, elementary school students average 44 minutes a week on science.

Only one-third of the nation's high schools offer more than one year of mathematics or science.

Only one-sixth of all high school graduates in the U.S. have taken a junior and senior level math and science course.

Only fifteen percent of the male and seven percent of the female students in California take three or more years of high school science.

Achievement scores nationwide have declined since the 1960s. In 1979, mean SAT scores were 427 for verbal and 467 for mathematical aptitude, out of a possible 800, down from the 500 for both categories which had previously been established as the standardized average.

The number of electrical engineering graduates in the U.S. has remained the same for the past 10 years, despite a tremendous growth in the electronics industry.

An important missing ingredient is money. Many schools nationwide have been forced by budget constraints to reduce equipment acquisition to an austerity level. The lack of new equipment may soon impair the ability of our schools to offer state-of-the-art technology training. In the last ten years, for example, shortages of equipment and supplies have cut by more than half the exposure of American students to any form of laboratory experience -- even of those students who take science.

In particular, equipment shortages undermine the ability of our schools to teach computer literacy. Computer literacy -- a key to proficiency in the information society -- has become recognized as the legitimate concern of the educational system. The State of Minnesota, to cite one example, requires all of its high school graduates to demonstrate skill and familiarity with computers.

We believe S. 2281, The Technology Education Act of 1982, is an excellent Congressional initiative to address these problems. It is of particular interest to Apple because it provides a means whereby the private sector can participate directly in improving technology education.

This Act offers a liberalized charitable contribution deduction for donations of computers to elementary and secondary schools. It extends and liberalizes present law, Section 170(e)(4) of the Internal Revenue Code, applicable to contributions of scientific equipment to college and universities.

The bill provides a deduction equal to basis plus one-half the difference between basis and fair market value. This deduction is limited to twice basis. The net effect is to provide a sharing of costs between government and industry, with government bearing most of the direct costs and industry most of the indirect costs. The governmental costs, however, are more than compensated by the fact that the value of the equipment received by the schools will far exceed the revenue loss to government.

An important aspect of the bill is that it raises the corporate limitation on charitable contributions from ten percent to thirty percent for the period during which the law would be in effect. This provision allows companies to provide equipment to the schools quickly. Any reduction in this limitation would reduce the amount of equipment made available to the schools, as companies would not be able to obtain benefit for their deductions.

If this bill is enacted into law, Apple is committed to giving a personal computer system to tens of thousands of public and private schools throughout the United States. In carrying out the program, Apple will incur millions of dollars of administrative, distribution, warranty and other costs.

The impact of Apple's program will be most significant in the poorer school districts where budget constraints have been most severely felt. Students in such districts face a clear competitive disadvantage in the job market of the future, compared to students from areas of affluence.

We believe that passage of this bill can have an immediate and profound impact on our school systems. It will have long-range importance both in terms of America's technological strength and the ability of our people to find and competently hold jobs in the society which is now emerging. The computer is at the epicenter of the information revolution, and computer literacy in the late 1980s and beyond will be virtually as fundamental a skill as verbal literacy is today.

Let us begin to meet this national challenge by enactment of the Technology Education Act of 1982.

Senator DANFORTH. Senator Dole had some questions which he would like to submit to you, to be answered in writing for the record.

Mr. JOBS. Sure.

[Mr. Steven Jobs' responses to questions from Senator Dole follow:]

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May 18, 1982

The Honorable Robert Dole
United States Senate
2213 Dirksen Senate Office Building
Washington, D.C. 20510

Re: S.2281

Dear Senator Dole:

The following are my responses to the questions submitted to me on May 7 at the Senate Finance Committee hearing on S.2281. We appreciate the opportunity to address your concerns regarding this bill.

At this point, we might add that while the questions are valid, our position is no different than companies, including ourselves, who are currently able to make contributions to colleges and universities. Thus the entire issue of cost sharing has recently been reviewed by Congress, with the result that Congress has approved the same arrangement that we are recommending. The major issue, therefore, is not the sharing of costs, but whether elementary and secondary schools should benefit in the same manner as universities and colleges.

Question 1: Your statement on page 6 admits that the government will bear most of the direct costs of Apple's contribution. In fact, I am told, if we assume Apple is a 46% marginal rate taxpayer, the government picks up 92% of the average direct costs of each donation. If this program is to be a "partnership between government and private industry" as you claim, shouldn't I ask my "partner" to pull a bit more of the load?

Answer: Let me first emphasize that although miniscule from a governmental scale, the project we are proposing is an enormous one from Apple's point of view. The direct costs are significant, but do not comprise the total cost of such a program. We estimate that it will cost Apple over $100 per computer in indirect costs, in addition to our share of direct costs. If Apple gives a computer to 100% of the over 100,000 schools in America, this would total over $10 million in after tax expense to Apple. Industry analysts estimate that Apple will earn $50-60 million in fiscal 1982 (ending September 30). As you see, $10 million expense would represent 20% of this year's earnings. I feel 20% of a corporation's earnings represents a very sizable participation in the project.

Another global way of viewing this program is that Apple is willing to sell computers to the government at below our cost. Apple has never sold anything below its cost before, and I think you will find it unusual for a company that is selling a product in very high demand to make such an offer.

In addition to these costs, Apple is willing to direct its corporate resources, know how, expertise and capital to the purpose of providing a computer in every school in America. Many key employees and resources of Apple will be involved in this program rather than in profit-making projects. There is no quantifiable cost to such involvement, but it is significant.

We believe that the use of Apple's resources and its share of the direct and indirect costs represent more than a fair participation in our proposed partnership with government. (See answer to Question 2 for detailed breakdown of indirect costs.)

Question 2: Your statement refers to industry bearing most of the "indirect" costs of these contributions, while the government pays the direct costs. The direct cost per microprocessor, I am told is somewhere in the neighborhood of \$500 to \$600. Outside of the very expensive use of your time in lobbying this bill, what are these "indirect" costs and what do they amount to per microprocessor?

Answer: Please note that the \$500 amount covers all items we would contribute and not just the microcomputer. The indirect costs vary with how the project is actually structured and implemented. Under one of the least costly alternatives, we forecast the following cost per unit.

Distribution, handling, Warranty	\$60	
Interest cost	53	
Computer support	20	
Administration	50 to 100	
Development of manuals, packing, software, etc	10	
	\$193	to \$243

Since neither we nor anyone else, have ever undertaken a program of this magnitude, it should be emphasized that the administration costs are estimates only.

Question 3: When we talk about cost or cost basis, in applying the twice basis rule we are really talking about the average cost of inventory, not its marginal cost. Your marginal cost, the cost to produce Apple Computer 100,002 should be much less than average cost. So if the government is paying 92% of your average cost then aren't we really paying some higher percentage of marginal cost? Perhaps more than 100%.

Answer: We do not anticipate any significant marginal cost savings as a result of this program. Apple will ship over one-third of a million computers in 1982 and many more in 1983. Even if Apple were to give each of the 100,000 schools in the United States a computer, this would constitute at most a 15 to 20% increase in unit volume. Over 75% of our direct costs consist of materials. A 20% increase in volume would not noticeably affect material prices. The same result is true of direct labor, where the increased volume may produce some slight efficiencies, but not really produce any meaningful reductions. There may be some small savings in fixed overhead, but fixed overhead is a very small portion of our direct costs.

Consequently, the use of average cost to compute the tax deduction does not produce a much different result than the use of marginal cost. It is impossible to estimate the exact difference at this time, but in any case, the government's cost will be below 100%.

Question 4: Your statement indicates that if we do not increase the 10% limitation on corporate contributions to 30% "companies would not be able to obtain benefit form their deductions." Some of your competitors have indicated that this increase would have no effect on them - even if they were to match Apple contribution by contribution. For what companies besides Apple is this provision necessary?

Answer: It is difficult to address the financial requirements of other companies. However, in our particular circumstance, we would be unable to go forward with the full program unless the limitation was increased to 30%. Can we live with something less than 30%? Yes, but we would have to scale down our participation, with the result that less schools would get computers.

Question 5: Have any companies other than Apple indicated a definite intention to take advantage of this provision?

Answer: Many of the companies we have spoken with supported the bill and indicated that they would make contributions under the proposed law. At least one company has announced its support of the bill. We believe other companies will do the same.

Question 6: Are you familiar with the Singer case? (Singer Company v. U.S. Court of Claims, 1971). In that case the Court of Claims concluded that discounts the Singer Sewing machine Company gave to schools when they bought sewing machines were not charitable contributions because Singer expected a return in the nature of future increased sales. How do you distinguish your case from Singers'?

Answer: A key finding in Singer is that the predominant interest of Singer was to enlarge the future potential market by developing prospective purchases of home sewing machines and more particularly Singer sewing machines. It is not Apple's predominate interest to enlarge the market for computers or Apple computers through this program.

Our industry has already been acknowledged in the press as one of the fastest growing industries of our times. In 1982 our industry will ship over 1.5 million personal computers and this quantity is projected to increase dramatically over the next several years.

However, many schools are unable to afford these computers, and it is our predominate interest to help educators meet the technology education challenge of today. Unlike the contributions in the Singer case, our program would deal with a recognized national education problem. We realize that as a result of our program, people may decide to buy an Apple computer. This is an incidental benefit, and one which we cannot avoid, but not one which would be the predominant motivation of the program.

While we do not believe Singer is applicable to our proposed contribution, any time a manufacturer gives equipment to a donee who may ultimately become a customer, the Singer issue may be raised. Accordingly, we recognize that S.2281 must be amended to eliminate this possibility if we are to proceed with our program.

If the above responses raises any further questions or concerns, we would welcome the opportunity to deal with them. We hope that you will see that S.2281 will do an extraordinary amount of good for our educational system. We hope to obtain your support in this endeavor.

Very truly yours,

Steven Jobs

Steven P. Jobs,
Chairman of the Board

Enclosures

SPJ/vjg

Senator DANFORTH. I want to ask you some questions.

First, Mr. Fish, here is one of the points that Mr. Chapoton made this morning, as I understand it. He said that there are a lot of businesses who would want to give things to the schools. They might want to give basketballs or school supplies or textbooks to the schools. If they do that, they can only deduct either the cost of the equipment they give or they give cash.

Therefore, he says that if we were to pass this bill we would be carving out a special exception for computer equipment, creating a difference than other possible things that could be given to schools and, on the other hand, if we allow this to be a precedent for everything else, we would never get control of it.

What I would like to ask you is, Do you view these machines as being all that special? Why should we have some special rule for computers instead of, say, baseball nets?

Mr. FISH. Well, first of all I would like to have his list of people that will give us things. I have been working on this for a while, and I haven't found them. We have programs that are going down the drain because of it.

First of all, in terms of our resources, we are very, very hard-pressed to maintain any textbook purchases, any purchases of anything in our budget this year. We have already cut $18 million out of a $300 million budget. We are typical of districts in California and in a number of other States so we do not have the resources.

Second, the computer is not part of our ongoing program now in the basic instructional program. We have extra supplemental activities which are very good and show us great promise. We can achieve a cost-benefit saving with computers that is phenomenal. So we believe and we know, and I have covered it in my written testimony rather extensively, that the computer as a responsive device which provides an immediate answer for a student has a capability that no other technology has that we have experienced before.

You can show the best movie, and you do not know if the person fell asleep or not. Every political figure who has given a speech knows that the speech given may not be the speech that the person hears. The computer has the wherewithal in its programing to learn what the response is.

Also, because it requires very structured work, I see it as an improvement to instructional programs. In order to program instruction for the computer, you have to have your educational program in good order. I look on it as a reform device.

But above all, and most important, the rate of technology change in this country is occurring so quickly that if we don't bring our young people into this program, with Government encouragement, there are many people who say, "Well, the old tradition will always go on."

I brought up the example of the slide rule for that purpose. Slide rules are gone. That technology is gone. That is past us. Our Nation must have computer technology. It is where the employment is; it is where the opportunities are; it's being shown by what's happening in the South Atlantic technological war right now and we don't have the wherewithal. Frankly, you can even see this generation gap within this room.

My son saved his money, bought an Apple computer, and he promises he may teach me how to program if I'm a good to him. I say that facetiously, but the point is that my son is ahead of me. He is fortunate, because his parents work. They can put together the money to do purchase a computer.

If we don't have computers in schools, there are going to be many children who never have such a benefit. And the gap that we see occurring within our society between the haves and the have-nots will expand. That's a very real concern.

Senator DANFORTH. Is it your view that these computers are not in fact like other things?

Mr. FISH. They are not like other things.

Senator DANFORTH. Is it your view that they are increasingly essential in the education of kids?

Mr. FISH. Absolutely.

Senator DANFORTH. It is your view that they would require an additional expense for something that is new in the school's budget and that the year 1982 is not a very good year for schools, particularly less than well-heeled schools, to be buying expensive new equipment?

Mr. FISH. That is absolutely right. To come up with a comparable amount of money for my district that would match what I see here, and I've not talked with the Apple Computer chairman until this morning—would probably be $300,000 to $500,000 and we haven't got it.

Senator DANFORTH. If you don't have it, who does?

Mr. FISH. Oh, gosh——

Senator DANFORTH. So the schools in the city of St. Louis don't have it either?

Mr. FISH. No, probably not, and those school districts or schools in the disadvantaged areas I know don't have it. I spoke with a person—I won't mention the city his from, but I could give it in private—in a district with 35,000 students, in the South. He said, "Oh, yes, we've got a computer. We've got one TRS-80," which is the basic Radio Shack computer. They have one, for a school district of 35,000 kids.

Senator DANFORTH. All right.

Now let me ask you some questions, Mr. Jobs. I want to be very frank with you, because I think we've got to face substantial opposition from the administration and some others.

Mr. JOBS. Sure.

Senator DANFORTH. Is this an "Apple bill"? Is this something that was dreamed up by one of a number of competitors and that your company is all set to take advantage of it, and therefore you would gain a competitive advantage over other companies? Once these were installed in the schools, wouldn't there be a generation of people who were hooked on your brand? Would not that be a tremendous promotional advantage for Apple if nobody else was interested in doing this?

Mr. JOBS. That's exactly why our competitors would never let that happen.

First of all, the people we compete with most ferociously in the marketplace, our arch competitors, are Tandy-Radio Shack, IBM, DEC, Digital Equipment Corp., Hewlitt-Packard—soon to be several

Japanese companies. We are the smallest of those companies in the marketplace. Our sales this year will be approximately $600 to $700 million. Those companies I mentioned are all in the multibillion-dollar class.

Second, though the concept of the bill was originated with Apple, I think very shortly I will be able to present you with letters supporting and pledging to participate in a major way on this bill by several of our arch competitors. I hope to have those within about a week. Those include Tandy and Atari, in particular.

Senator DANFORTH. So at least two other companies are interested?

Mr. JOBS. Absolutely. I talked to IBM yesterday, and they have a government affairs department that is probably larger than the U.S. Senate, so it is going to take them a little longer to respond. [Laughter.]

Senator DANFORTH. Another point was made that obviously there is something in this for Apple, or for any other company that does it. Why should we be helping a company to improve its own position?

Mr. JOBS. Again, what this basically amounts to is a sharing of costs between the public and the private sector. As I've outlined, I think this is going to cost the private sector substantial amounts of money.

I guess we obviously have an enlightened self-interest point of view in this in that a generation of kids growing up who know how to drive automobiles is going to buy more automobiles eventually than a generation of kids growing up that don't know how to drive. We understand that and hope someday to take advantage of that and potentially even recoup our money, and many times that.

But the original idea for this bill has come out of the fact that we have seen what these tools can do in schools, and we are all going to be around when these kids grow up and hit the job market. I think the reasons that we are very interested in doing it is because we have seen the effects of these tools.

I don't see any major short-term windfalls. There may be some long-term major benefits.

Now, the computers are going to get into the schools anyway, one way or the other. At least they are going to get into the middle class and upper class schools. But it is going to take time. The nature of this bill is simply to shorten that time and to accelerate the exposure of kids to computers. It is going to happen anyway, but it might take 5, 6, or 7 years.

Senator DANFORTH. My answer to the question would be: The fact that something may be in the interests of business doesn't mean that it is not in the interests of the individual.

Mr. JOBS. Sure.

Senator DANFORTH. We put into the tax law major reforms in depreciation in 1981. There were people who said, "Oh, this is promiscuous." It seems to me that we have to be following policies which are aimed not at preventing success for one kind of business or another but rather we should follow policies which will benefit the United States.

I happen to be the chairman of the International Trade Subcommittee. The United States is falling behind. We are falling behind, extremely. It is absolutely remarkable, the ability of just one country, Japan, to gain a competitive advantage over the United States. Why is that so? Not because they have natural resources that are better than ours; they don't. They are more dependent on importing natural resources than we are. But they are able to project into the future what the needs of their country and the needs of the world are going to be and plan accordingly. They are able to develop a partnership between Government and business to achieve goals for the country as a whole.

I have absolutely no knowledge of computers, and I'm sure I never will. But I am also confident that our country has to have a large number of people who are as smart and as well prepared in schools in the sciences and technology as their counterparts are in any other country. That is my understanding of the thrust of this bill.

Another point was made that 94 percent of the cost of this is going to be borne by Government; Government is in essence going to be buying computers at cost, and that's just about right. The effect of this is that the Federal Government would be buying computers at cost less a percentage.

Mr. JOBS. Of the direct cost, yes. There are a lot of indirect cost associated with it as well that will be borne by us.

Senator DANFORTH. Will you spell those out for us?

Mr. JOBS. Sure. Simple things; as an example, the costs of the distribution of the computer, the cost of the servicing of the computer, the costs of, in general, many kinds of royalties on the software that we include in the computer. All of those are indirect costs and are not eligible for this liberalized deduction.

We have estimated the cost at a little over $100 per computer that will be borne by us that will not be eligible—$100 after-tax cost to us per computer. That's where we get our number of over $12 million for computers for 103,000 schools.

So this is not exactly a freebie for us or anybody else that participates in it. It is an investment.

Senator DANFORTH. Gentlemen, thank you very much. Do you have anything else? You were the only witnesses in favor of the bill. Do you have any other points that you would like to make?

Mr. FISH. I would like to comment on the absence of other witnesses from educational groups on this bill—it is relatively new, and school people move exceedingly slow. I have had expressions of interest from most of the major groups concerned with schools—school administrators, school principals. A National School Boards Association staff member talked to me yesterday. When he found out I was testifying he expressed interest. They have not had an oportunity to go forward, but I believe that they will. I am confident that they will. I believe that education will jump on this bill. I know they will.

Mr. JOBS. We have received a few thousand letters ourselves about it.

Senator DANFORTH. Thank you very much.

Mr. FISH. Thank you.

Mr. JOBS. Thank you.

Senator DANFORTH. We will now proceed to S. 1928 and Mr. Doyle.

Mr. Doyle, please proceed.

STATEMENT OF ARTHUR J. DOYLE, PRESIDENT OF KANSAS CITY POWER & LIGHT CO., KANSAS CITY, MO.

Mr. DOYLE. Good morning, Mr. Chairman.

My name is Arthur Doyle. I am chairman and president of Kansas City Power & Light Co., one of some 27 electric utilities of this country that engaged some litigation with Westinghouse Electric Corp. concerning uranium.

I have filed my written testimony on behalf of the 22 electric utilities that are represented here today, and I believe that will provide the committee with sufficient background.

Instead, this morning I would like to direct my remarks to my reaction to the position announced here this morning by the Treasury Department, which I must admit came to me as somewhat of a surprise.

The Treasury announced strong opposition to Senate bill 1928. Well, that came as a surprise, first of all, because my understanding had been that over the past 2 years that these discussions have been going on with the Treasury Department that there was no real opposition by it to the merits or substance of this proposed legislation.

I was more surprised, though, at the grounds upon which that opposition was predicated. Treasury took the position that this is private relief legislation, and the utilities should go to court and hammer out each one of these in the courts.

Well, I guess you might call it private relief legislation, but if you did that you would have to define private relief as that which affects some 55 million of our consumers in this country directly and immediately. That is what I propose to mention this morning.

Second, the Treasury says, "Go to court and try each one of these on an ad hoc basis." The very purpose of this legislation that we are bringing before the Congress, is to prevent that kind of an unnecessary waste and time.

The real purpose of this legislation is merely to clarify what we believe to be existing law, and we do not stand alone in that position. I have before me a letter from the staff of your Joint Committee on Taxation dated April 22, 1982, in which it, referring to this bill, says, "It could be viewed as codifying present tax law treatment of discounts and price reductions. As such, the bill is not estimated to affect fiscal year tax receipts."

Now, Mr. Chairman, let me, if I may, just try to pinpoint for you and the committee exactly why I say that this bill is designed to clarify existing law and to benefit immediately and directly 55 million consumers—that's one-quarter of the population of this country—in avoiding unnecessary tax litigation expense.

Treasury says—and I can appreciate its administrative position here where it has one of its agencies taking a position concerning the substance of the matter. Treasury does not want to come before the Congress and pull the rug out from under that agency decision and say, "No, we're going to reverse it." But I think where we have an item of this magnitude, the Congress should take a good hard look at exactly what it is that we are talking about.

The question, to me, is: Was there any realized gain which should be taxed? Knowing full well that, if the utility is taxed that under State regulatory law, that tax must be and will be flowed through directly and immediately or eventually to the consumer.

I suggest that what actually happened was, when Westinghouse lost the case on the merits and was required to perform the contracts, the court, recognizing the magnitude of some potential $2 billion of damages for which Westinghouse would be liable on the uranium contracts, did not want to have another Lockheed or Chrysler in this country, appointed a special master and said "Try to work this out so that the utilities and their consumers will be fully protected on the deal they made, their original contract, but do it in such a way that performance of those obligations will not bankrupt Westinghouse." That's precisely what we did.

Now, then, this was not a voluntary transaction by us or our customers; it was involuntary. We agree to pay a higher price for the future uranium to be delivered—that was the quid pro quo for the discounts we purchased.

I am prepared to answer questions, Mr. Chairman.

Senator DANFORTH. Would you like to proceed further? That 5 minutes is awfully short when you are the sole witness for a bill.

Mr. DOYLE. Thank you, Mr. Chairman. Just a few more remarks.

The structure of each of these settlements in general and in detail was this: The utilities had provided uranium cover, some to a greater extent, some to a less. After they adjusted the amounts of uranium they needed, most of the utilities agreed to take uranium and fuel from Westinghouse; but instead of paying $8 to $10 per pound base price, they upped it to about $30 per pound.

Now then, that was the consideration which permitted Westinghouse to perform those adjusted fuel supply contracts. Now, what did they get for it? They got cash in part. To cover what? Past losses on what they had already incurred for cover uranium. But also they got the right or entitlement to buy, which they might exercise, future goods and services for Westinghouse, at discounts. Now, it was those forgone profits in the future out of which Westinghouse hoped to finance its liability here. These future goods and services go on for not just a year or two but for a decade or two in most instances.

Secondly, I point out that these discounts are conditional. There is not an unconditional obligation on the part of Westinghouse to provide this discount to the utility. It is only if the utility should elect to buy a particular piece of goods or some services. But I suggest no utility is going to buy a particular piece of equipment from Westinghouse even at a 50-percent discount if that piece of equipment has no value to the utility at that time.

As a result, what do we have here? We have a Treasury Department, or rather I should say IRS, contrary to some tax cases like the *John Graf* case, saying, "We are going to try to measure the present value of that contingent opportunity to exercise that option and get this discount at a future time, and we are going to tax you on that value today."

Now, if our current tax liability goes up, then under State regulatory law the commission has to recognize that expense in our rate regulatory treatment. Therefore, it is going to be passed on to our ratepayers. They are the ones that are going to suffer.

We suggest to you, as the staff of the Joint Committee has found, this is merely clarification of existing law. This Congress should address this on a substantive basis, take a look at it, and say, "No, we are going to protect the ratepayers."

How are the taxpayers protected? Because in the future, as this bill requires, when and if a utility does exercise that right to purchase at a discount, then the only thing we will have for a tax basis of that future goods or service will be its reduced cost. Therefore, it is a reduced operating expense and a higher income tax liability. Or, if it is a capital good, it will be a reduced cost and therefore a reduced depreciation expense, and therefore a higher tax liability.

So what we have here is a situation where actually the IRS is saying, "No, we are going to front-end this. Utilities, you go out and get a pile of money, pay it over to us, let's go ahead and litigate, and we will take care of it in the future." I suggest that is not in the best interest of 55 million consumers.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF ARTHUR J. DOYLE BEFORE THE SENATE COMMITTEE ON FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT CONCERNING S. 1928 May 7, 1982

I am Arthur Doyle, President and Chairman of Kansas City Power & Light Company, Kansas City, Missouri. I am here today on behalf of 22 electric utility companies that would be affected by S. 1928, a bill clarifying the federal income tax treatment of certain future discounts that may be received by the utilities in settlement of their uranium contract litigation with Westinghouse Electric Corporation.

The electric utilities affected by S. 1928 began nuclear power plant projects in the late 1960s and early 1970s to provide a cheaper electric energy source for the public they serve. In that connection, the utilities entered into contracts with Westinghouse for their purchase of nuclear plant equipment, uranium and fabrication of that uranium into usable fuel rods. The fuel supply contracts provided for the delivery of the fuel by Westinghouse over a period of many years--some for decades, thus assuring the utilities a low fixed base cost for their long-term uranium fuel requirements for operation of those nuclear plants.

When Westinghouse entered into the fuel supply contracts, it had little or no assured source of supply for the amounts of uranium that would be required to perform those contracts. Westinghouse apparently intended to acquire the necessary uranium from time to time primarily in open-market purchases to meet its contract obligations to supply the fuel to the utilities at contract prices based on uranium at $8 to $10 per pound. However, in the mid-1970s, the market price of uranium began rising precipitously. By the summer of 1975, the market price had reached $26 a pound. In September 1975, Westinghouse notified the utilities that it would not perform its obligations to supply uranium under the fuel supply contracts, claiming that under the Uniform Commercial Code, the commercial impracticability of the uranium contracts excused it from further performance.

The utilities promptly filed suit against Westinghouse for specific performance of those uranium contracts. The suits also included alternative claims for damages in the event that specific performance was not available as a proper remedy. The cases were virtually unprecedented in size and commercial significance. On one side were major public utilities that serve more than 55 million consumers through the nation, one quarter of the nation's population. On the other side was a major American corporation that initially estimated its potential liability to be over $1 billion. Thereafter, as the market price of uranium rose to $42.50 a pound in 1976, Westinghouse's estimated liability grew to some $2 billion.

The lawsuits filed against Westinghouse in the Federal District Courts throughout the nation were combined in a multi-district proceeding before the Federal District Court sitting in Richmond, Virginia. After an extended trial on the sole and separate issue of Westinghouse's liability for performance of its contracts, the District Court ruled that Westinghouse was not excused from performance. Given the staggering magnitude of Westinghouse's potential liability for damages and the threat that posed to Westinghouse's solvency, the District Court strongly urged the parties to negotiate settlements that would relieve the utilities and the public they serve without bankrupting Westinghouse. The Court appointed as Special Master Dean Spong of the Marshall-Wythe School of Law at the College of William and Mary, who will testify here today. He was appointed by the Court to mediate and supervise settlement negotiations. Under Dean Spong's direction, the damaged utilities negotiated separate settlements with Westinghouse. The settlements differed in their exact details, but generally and, I understand, for the most part embodied the same type accommodations in settlement of the original fuel supply contracts.

The settlements aimed to place the utilities and their customers in the same economic position (i.e., without dollar loss) as if Westinghouse had performed its original fuel supply contracts over their respective terms of years, but in a manner which would give Westinghouse the opportunity to bear portions of the cost with foregone profits on goods and services which might, in the future, be purchased by the utilities from Westinghouse.

I'm advised that the settlement contracts between Westinghouse and the utilities generally contain the following compromise approach: After adjustment of the utility's fuel supply requirements because of interim changes including uranium cover purchases made by the utilities after Westinghouse defaulted, the utilities renegotiated adjusted fuel supply contracts with Westinghouse and agreed to pay Westinghouse significantly higher base prices for the uranium component of that fuel. Westinghouse in turn paid the utilities certain amounts of cash upon settlement and provided the utilities with the right to purchase from Westinghouse future goods and services at significant discounts from the future market prices. Some of the settlements also provided the utilities with specific shares in amounts that Westinghouse might recover from the uranium cartel which Westinghouse alleged to have caused the increase in world market uranium prices. The cash damages received by the utilities were largely for past losses or excess uranium costs they had incurred when Westinghouse's default forced them to buy cover uranium on the open market at the then higher uranium prices. The agreed discounts simply entitled the utilities to price reductions on other goods and services that they might purchase from Westinghouse in the future. Some of the discounts were subject to contingencies that may never occur. For example, half of the settlement in one case (over $100 million) was contingent upon completion of a second nuclear plan which now has been cancelled.

The future discounts were the linchpin of the contractual renegotiations. The utilities obtained the right to the future discounts in return for their agreement to pay Westinghouse higher base prices for the uranium components of the adjusted fuel supply contracts, thus enabling Westinghouse to perform the adjusted fuel supply contracts. Westinghouse would have the financial ability to compensate the utilities through this mechanism because in the future it could sell other goods and services at a discount and still cover most of its out-of-pocket expenses for those goods and services that might be ordered by the utilities to recover a portion of their higher fuel costs under the adjusted fuel supply contracts.

In a private letter ruling addressed to one of the affected utilities, the Internal Revenue Service has taken the position that the "value" of the contingent future discounts is taxable to the utility as a current income tax liability in the year the utility settled and renegotiated its fuel supply contract with Westinghouse. Because the utilities will receive whatever discounts they might ultimately receive from Westinghouse over a period of many years--up to several decades--the Service's position has several negative consequences for the utilities and their customers.

The position taken by the Internal Revenue Service would require the utilities to pay higher current income taxes. With respect to the utility's increase in its current income taxes payable, various State utility regulatory commissions might

(a) treat all current income taxes payable by the utility as an operating expense for test year purposes and, thus, immediately pass on the utility's increased income taxes to its customers in the form of higher electric rates;

(b) require amortization of the utility's additional income tax liability over a specific period of years for ratemaking purposes, with the unamortized balance added to the utility's rate base, in which case (i) the amortized portion of the additional income tax liability would be passed on immediately to the utility's customers in the form of higher rates, and (ii) the utility's "carrying cost" of the unamortized balance of the additional income tax liability would also be passed on immediately to the utility's customers as additional return to the utility, thus further increasing the electric service rates to its customers; or

(c) require amortization of the utility's additional income tax liability over a specific period of years for ratemaking purposes, but without inclusion of the unamortized balance in the utility's rate base, in which case the amortized portion would be passed on immediately to the utility's customers in the form of higher rates and the utility would not be

> given the opportunity to earn its authorized rate of return as fixed by the commission, but it would nevertheless be required to bear the "carrying costs" of the unamortized balance of the additional income tax liability and as a consequence, the utility's credit ratings would be lower and its cost of financings would be higher and that additional cost would be borne indirectly by its customers over the future years.

In any event, it is obvious that the Service's position would force the utility to enter into current tight capital markets at higher costs of money to provide, at least initially, the funds to pay the increased income taxes on "values" that they may never receive. The real impact of the Service's position is on the consumers who would pay higher electric rates either immediately or in the future because of the increased financing costs occasioned by the premature tax. Increased utility borrowing to finance the current increased tax payments on future discounts would raise the utility's cost of capital and certainly would entitle it to collect a correspondingly higher rate of return from the public they serve. Thus, the real effect on the Service's position is to increase the cost of electricity to customers.

S. 1928 deals only with the Federal income taxation of future discounts that may be received under the renegotiated Westinghouse contracts. The bill does not affect the tax treatment of cash received by the utilities for a portion of their damages occasioned by the Westinghouse default. The bill simply makes clear that under present law, the future discounts are not taxable income to the utilities during the year of the settlement. Instead, the discounts will, in the future, reduce the cost for tax purposes of the goods and services bought by the utility at a discount as and when purchased. As a result, the utilities would thereafter take smaller deductions for operating and/or depreciation expenses in connection with the items purchased at discount, thus increasing their potential tax liability in those year commencing when they actually received such items.

We believe the present law permits the utilities the same income tax treatment for the future discounts as would be provided by S. 1928. This bill would simply clarify that law and assure that our customers would be relieved of any increased electric rates that would be caused by the premature imposition of a current tax

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liability for future discounts that might be received by the utilities over several decades. Because the bill simply codifies the law, the Joint Committee on Taxation has estimated that S. 1928 causes no revenue loss to the Treasury.

Simply put, we disagree with the interpretation by the Internal Revenue Service of the present tax laws. We are asking the Congress to clarify the meaning of the present tax laws. In doing so, S. 1928 provides for the correct, efficient and uniform resolution of a tax matter affecting 22 electric utilities and over 55 million consumers throughout the nation. It spares both the consumer and the Government the unnecessary expense of litigating the matter in many tax cases tried throughout the nation, and it provides these benefits at no cost to the Treasury.

Senator DANFORTH. You say there are 55 million consumers of the affected utilities. In the event this bill is not passed, is there any doubt that the fact that income would be realized immediately—is there any doubt that that would be passed on in the rates of these consumers?

Mr. DOYLE. Well, yes, I think there is some doubt, Mr. Chairman, and this is why I say it that way. We don't think that it's a simple matter. We firmly believe that under the *John Graf* case and other cases decided like it, that——

Senator DANFORTH. What I am saying is that if it turns out that you realize income at the day of settlement, and that you have thereby incurred a tax liability, would that increased tax liability, by virtue of immediately realizing the income, would that be reflected in the rates paid by your consumers?

Mr. DOYLE. Yes, Your Honor—Mr. Chairman, it certainly would.

Senator DANFORTH. I am an honorable. [Laughter.]

Mr. DOYLE. I beg your pardon. Yes, Mr. Chairman, indeed it would. Under State law and under constitutional law, any tax obligation imposed upon the utility that becomes a current income tax obligation must be reflected in the rate structure and thus would be passed on.

It can be done in one of two ways by the State regulatory commissions, either immediately, today, as a current operating expense and passed on 100 percent, or the commissions could say, "No, we are going to amortize this over a period of, say, 5 years, or something, in which case only one-fifth would be a current expense and show up in the rates in that fashion, but the remaining four-fifths would go into rate base and we would earn a return on that. In that case, then, the customer is going to pay even more because of the delay over the 5-year period.

Senator DANFORTH. Do you hear from your customers when rates go up?

Mr. DOYLE. Regularly.

Senator DANFORTH. Do you say that it is not absolutely certain, but you would be buying future goods and services at a discount? Therefore, you have received an asset, namely an ability to buy at discount in the future, but that would actually have to be exercised in order to take advantage of it?

Mr. DOYLE. That is absolutely correct. I think it would be unique if, for example, Kansas City Power & Light Co. and K.G. & E. were to buy all of the goods and services for which we would have the right to buy at some discount. We were required, in order to facilitate an arrangement where Westinghouse could compensate or give us the opportunity to be compensated at 100 percent, that we take goods way out into the future.

When we signed that and still today, we believe that there is a good possibility that we will take them. But there are some who, I would say, because of changing circumstances, changing technology, will probably forgo purchases. For that reason, there are other instances like our friends in Missouri at Callaway II: half of its $100 million settlement was related not to Callaway I but to Callaway II which was canceled. The settlement with Westinghouse specifically provided that if Callaway II were canceled, then half of these future goods and services at discounts would be discontinued. That happened in a subsequent tax year, I might point out, and others are subject to many contingencies.

Senator DANFORTH. Do you have anything else you would like to add?

Mr. DOYLE. No, except to say that I'm rather disappointed. After attempting to work this out with the Department of the Treasury over a period some 2 years now, Treasury finds it necessary to support IRS and says, in effect, "Let's go to the courts and fight each one of these out," which would do nothing more than impose additional litigation expense and costs which again would have to be borne by the ratepayers. We think it is completely unnecessary. We firmly believe that when we were damaged and injured by Westinghouse's default, and we settled, and we settled under the court's supervision in a way to protect Westinghouse, how did we realize any gain?

You know, if I had an accident and I sued because my leg was chopped off, and part of the settlement was they gave me a pair of crutches at discount, is that discount gain to me? No.

I am saying that in logic and good sense, none of the utilities had any realized gain in this settlement at all.

Now, technically you can conceive of theories of sales of options, but this was involuntary purchase of optional discounts on the part of the utilities. This wasn't a case where we were trading in options on the commodity markets.

We believe the law is clear. We understand, unfortunately, the position of the Treasury technically supporting a unique decision of one of its agencies; but we ask this Congress to give a good, hard look to this.

Senator DANFORTH. To even the hole in the settlement?

Mr. DOYLE. Yes; I would say it this way: The settlement for Kansas City Power & Light Co. and Kansas Gas & Electric Co., each 50-50 partners, resulted in a settlement on the basis of about $94 million, approximately, and that roughly was a measure between the uranium that we bought at a fixed base price of $8 a pound and the current market values at the time of settlement.

Now then, in settlement, though, we got $38 million in cash, which only protected us for the cover we had already bought in uranium at higher prices and an investment in a uranium venture.

It boils down to this: Part of the remaining damages has to do with these goods and services. In order for us to get the full $94 million benefit, we must buy all of those goods and services, whether we want them or not or whether they are usable or not. So I would say the probability of getting the full amount is not there.

Second, part of the $94 million was based on a percentage participation in the net proceeds of the uranium cartel litigation where Westinghouse sued a group, alleging cartel. That was about $7.5 million, I believe, of the $94 million. Now, that litigation has been pretty well wrapped up. It is my understanding now we will get about $2½ million of that. Therefore, right there, we have lost $5 million. Therefore, I can say now the settlement is down to $89 million. That's where we are.

But at the time we entered the contract we at least thought and believed we had the full opportunity to protect our ratepayers 100 percent.

Senator DANFORTH. Thank you very much, Mr. Doyle.

Mr. DOYLE. Thank you, Mr. Chairman.

[Whereupon, at 12:05 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

COUNCIL FOR AMERICAN
PRIVATE EDUCATION
1625 Eye Street, N.W., Washington, D.C. 20006

(202) 659-0016
Robert L. Smith
Executive Director

May 21, 1982

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Senate Committee on Finance
United States Senate
Washington, D.C. 20510

Re: [redacted]
of computers and other sophisticated technological
equipment to elementary and secondary schools.

Dear Mr. Chairman:

The Council for American Private Education representing about 80% of all private schools in this country through its 15 member organizations would like to go on record as endorsing the comments you have received from the U.S. Catholic Conference (letter dated May 14, 1982) regarding S. 2281.

Because Catholic schools contribute such a significant part of the nation's total private school population and because other denominational schools within our organization, having similar organizational structures, have the same problems with the Bill, we very much hope you can incorporate the langauge changes recommended by U.S.C.C.

With thanks.

Sincerely,

Robert L. Smith
Executive Director

cc. Robert Lighthizer
Chief Counsel
Senate Committee on Finance

[illegible] The American Lutheran Church • [illegible] Lutheran Churches • Association of Military Colleges and [illegible] • Christian Schools International • [illegible] Missouri Synod • National Association of Episcopal Schools • [illegible] of Independent Schools • [illegible] • National Catholic Educational Association • National [illegible] Day Schools • Seventh-day Adventist [illegible] School Association • U.S. Catholic Conference. Associated [illegible] Arizona, California, Connecticut, [illegible] Maryland, Michigan, Missouri, New Mexico, Oregon, Puerto [illegible] Virginia, Washington, and Wisconsin.

AMERICAN MOTORCYCLIST ASSOCIATION

P.O. Box 141 Westerville, Ohio 43081 Telephone (614) 891-2425
Telex: 245392

1982 MAY 18 AM 9 40

May 12, 1982

Senator Bob Packwood
Senate Finance Committee
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood,

On behalf of the American Motorcyclist Association, which comprises of a group of 135,000 members as the national voice for motorcycling interests in the United States, we are pleased to deliver this written testimony on SB 2214 (Schmitt, et al). We attempted to testify on the bill May 7 in person, but were denied due to the large number of commitments. Thus, we wish to make this comment available now, and urge that it be considered part of that record. It is being supplied to each member of the committee.

If you have any comments or questions, please contact us at your convenience.

Sincerely,

Gary Winn
Legislative Analyst
Government Relations

GW:mr

Enclosure

S-2214 Testimony

The American Motorcyclist Association is composed of 135,000 members nationwide who use motorcycles as daily transportation and for recreation. We will soon celebrate our 60th Anniversary as the national voice of the motorcyclist community. We wish to provide comments to the Senate Finance Committee on an issue of great importance to the 5.2 million registered motorcycle users in the United States. In short, we are concerned that S-2214, introduced by Senator Harrison Schmitt, et. al., would discriminate against an ever increasing number of consumers who select motorcycles as a transportation option to the automobile. Purchasers of autos would remain eligible for substantial interest deductions, and those, by virtue of choosing a motorcycle as their preferred mode of transportation, would not qualify.

Statistics supplied by the Motorcycle Industry Council, a non-profit trade association, indicate that in 1981, 1.14 million motorcycles were sold, in the United States, frequently as a primary or secondary mode of transportation. The likelihood looms large that consumer purchases of motorcycles would drop if the tax advantage of deducting interest was removed, since MIC reports that 30% of these sales are on installment plans.

An additional benefit to continued motorcycle sales and use is fuel conservation. Information available from the Motorcycle Industry Council demonstrates that motorcycles are among the most efficient vehicles available for commuter use. The MIC states that "on the highway, motorcyclists save the nation almost $300 million each year that would otherwise be spent on an additional ten million barrels of oil." (p. 12, MIC Statistical Annual, 1981) Motorcycles are even more fuel conservative than carpools of four passengers, and about twice as fuel efficient as a two person carpool. The possible loss of interest tax deductions removes an additional incentive that will result in reduced sales of motorcycles and would impede national goals of fuel conservation.

As a result of 1976 research, the U.S. Department of Transportation has projected that increasing numbers of Americans will turn to motorcycles as an economical, fuel efficient mode of transportation. A large percentage of these vehicles will be used primarily, if not exclusively, for commuting to and from work: AMA statistics show over 31% of its members use motorcycles for commuting purposes.

In terms of vehicle miles traveled (VMT), the DOT estimates that motorcycles will increase its VMT by a far larger margin than any other vehicle type. (See Figure one) Without the tax deduction for installment purchases, the predictions of increased usage and concomitant fuel savings would drop dramatically. Reduced usage would result from fewer sales of new motorcycles.

Figure 1

Estimated Vehicle Miles Traveled*

(Billions of Miles Traveled)

	1975	1990	% of Change
Automobiles	1,025	1,380	+35%
Single unit trucks	218	340	+81%
Multiunit trucks	57	103	+81%
Buses	5	5	--
MOTORCYCLES (emphasis ours)	25	92	+272%
Total	1,330	1,921	+31%

*National Highway Safety Forecast—A 1990 Traffic Safety Outlook, September 1976, page 21, fig. II-3, NHTSA.

Motorcycles used as personal transportation often match purchase prices of small automobiles, thus falling into the "large loan" category of installment purchases. In addition, demographic information collected by the American Motorcyclist Association shows that motorcycles are purchased by members who earn, on average, under $20,000. 67 percent of AMA members are presently making mortgage payments toward home purchases. When combined, these figures clearly indicate that as middle income families, AMA members are unlikely to itemize their income taxes to take advantage of the availability of interest deductions. The ability to combine mortgage interest and the interest accrued to their motorcycle purchase serves as an additional incentive to select this economic mode of transportation.

In summary, the AMA strongly feels its members and all motorcyclists should be included in the group that remains eligible for the installment interest tax deduction. Given the favorable fuel savings offered by the motorcycle users, a healthier consumer marketplace will result. An additional benefit to the continued tax deduction for installment purchases of motorcycles would derive from increased use and improved fuel conservation.

MIC
MOTORCYCLE INDUSTRY COUNCIL, INC.

1235 Jefferson Davis Hwy., Suite 1410 • Arlington, VA 22202 • (703) 521-0444

May 20, 1982

The Honorable Robert Packwood
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

The Motorcycle Industry Council (MIC) is pleased to submit comments on S. 2214, a bill which would eliminate the Federal tax deduction for consumer interest payments, with the exception of interest payments for housing, education, business, and most motor vehicle loans. MIC is a non-profit, national trade association representing manufacturers and distributors of motorcycles and suppliers of ancillary products and services.

While MIC applauds the overall thrust of S. 2214, we object to the fact that the bill would treat consumers wishing to finance motorcycles differently than it would treat consumers wishing to finance cars, vans, and light trucks. Under S. 2214, motorcyclists who itemize would no longer be able to deduct interest expenses associated with the purchase of two-wheel vehicles. However, based on the definition of "passenger automobile" cited in the bill, other motorists, including car, van, and light truck purchasers, would still be able to deduct such expenses.

Motorcycles are unique vehicles which offer individuals the combined advantages of personal mobility and fuel economy. To an increasing extent, commuters are turning to motorcycles for an efficient means of transportation and significant operating savings over other travel modes. In fact, a report issued by the Department of Transportation in December, 1980 indicated that a far higher percentage of motorcycle mileage is accumulated during commuting trips than car, van, or light truck mileage.

MIC urges you to take a close look at the potential impact of S. 2214 on the motorcycle community and to amend the bill to allow motorcyclists to continue to deduct the cost of financing fuel-efficient two-wheel vehicles. Thank you for considering our views on this important issue.

Sincerely,

John F. Wetzel

John F. Wetzel
Director
Federal Government Relations

JFW/wgv

SUBMITTED STATEMENT BY THE
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, AND
THE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY
OF THE SENATE FINANCE COMMITTEE
ON S. 2214 - TAX TREATMENT OF INTEREST AND DIVIDENDS

MAY 7, 1982

The AFL-CIO is opposed to the changes in the tax treatment of interest and dividends as proposed in S. 2214.

Section One of the bill would repeal several existing tax preferences for interest and dividend income and put in their place a measure that is even more costly and more beneficial to the wealthy. The other major aspect of the bill would deny some interest deductions of some taxpayers -- its purpose, according to the sponsors, is to eliminate an incentive to borrow. We view it as a piecemeal, unfair and unworkable measure which in the main would add to the tax burden of middle income Americans.

Neither provision of the bill comes to grips with the real issues involved in the manner in which the tax code shelters investment income or permits costly and inequitable deductions.

Specifically, Section One would repeal existing law provisions which allow individuals to (1) exclude from income up to $200 ($100 single) of dividend income, (2) exclude up to $2,000 ($1,000 single) of interest on "all-savers certificates" issued prior to 1/1/83, and (3) exclude, beginning in 1985, 15% of up to $6,000 ($3,000 single) net interest income. Net "interest" income is defined generally as interest income after deducting interest incurred as a business expense or for housing.

The AFL-CIO opposed the enactment of all those measures which, at the time, were also advocated as devices to increase savings. We noted that all the measures suffer the fundamental inequity that results from the fact that (1) only those who are able to save receive any benefit and (2) of those who can benefit, the value is directly related to their tax bracket.

We also objected on grounds that such measures do not increase overall savings levels, for any additions to private savings will come at the expense of larger government deficits and consequently more government fiscal pressures and higher interest rates. These current law provisions in F.Y. 1983, 1984, and 1985 cost respectively $2.3 billion, $1.6 billion and $1.7 billion. No evidence has ever been presented demonstrating that these devices have had or will have any positive effect on the overall level of savings. In fact, it is just as likely that such added tax breaks would have the opposite effect. That is, through increasing the after-tax income of the recipients, they can and will increase their consumption spending.

Appropriately, S. 2214 would repeal these provisions. Unfortunately, it offers as a quid pro quo a widening of the 15% exclusion to 25%, moving its effective date up by three years and broadening the provision to include dividend income as well as interest. Thus, under this substitute provision as much as $1,000 ($500 single) in interest and dividend income would be tax exempt. According to the Treasury this inequitable substitute provision would cost $2.2 billion in F.Y. 1983 and $3.1 billion in F.Y. 1984.

We should also note that widening the provision to include dividend income is particularly onerous on the heels of huge corporate tax breaks of the ERTA which are of particular benefit to stockholders. On that note we would also like to call attention to the extreme concentration of dividend income in the hands of the wealthy. A 1971 Commerce Department study, for example, found that the 1% of U.S. familes with the highest income received 47% of the total dividends and owned 51% of the market value of stock. Similar indications of concentration were presented in the 1977 University of Michigan Survey of Consumer Finances. According to that survey, 75% of the nation's families owned no stock at all, and only 9% of the families had stockholdings of $5,000 or more. And even at 1977 incomes of $25,000 or more, almost half owned no stock and over 70% either owned no stock or the value of their holdings was $5,000 or less.

Section Two of S. 2214 would do away with certain interest deductions that have been in the law for many years.

The tax deductibility of many personal expenses -- interest as well as numerous other deductions such as state and local sales taxes, gasoline taxes, etc. -- has been a long-standing subject of concern and controversy which has never been satisfactorily resolved.

We recognize the fact that such deductions are costly in terms of revenue foregone and generally provide greater benefits to higher-income taxpayers. And, in the past, the AFL-CIO has supported measures which affect certain of these deductions. But we have always insisted that such changes take place within the context of a total package of tax reform which is equitable and does not selectively "reform" certain provisions that are of questionable value and at the same time leave intact the huge loopholes and escape hatches of the wealthy.

S. 2214 is a case in point, illustrating the kind of piecemeal policies we find objectionable, for in the context of Section One's giveaways, what emerges is a package which provides even more tax breaks to the super-wealthy and compensates for the loss by adding to the burdens of some middle-income taxpayers. In addition, the specific provision makes no sense.

Specifically, Section Two would deny interest deductions on all consumer debt except automobiles, home mortgages and higher education. Because of the "fungibility" of money, these limitations could be avoided easily, particularly by those of greater wealth. Taxpayers could get around the provisions merely by borrowing against their homes, automobiles and businesses, and such options are much more likely to be available to the wealthy.

The net result, we suspect, is that moderate and middle income workers who do itemize deductions and borrow in order to purchase a major appliance, furniture and the like, will be denied a small tax break. Wealthier "borrowers" will merely shift their debts around to avoid any additional taxes.

In closing, we would like to point out that there is a tax bill, H.R. 6257, sponsored by Representatives Thomas J. Downey and James M. Shannon, which would raise badly needed revenue, add to equity and encourage savings through helping to build a stronger economy. We have attached the section-by-section summary of this bill, which has the full support of the AFL-CIO, along with a table showing its estimated revenue-raising effects.

THE EQUITY TAX ACT
(Section-by-Section Summary)

I. Individual Income Tax Provisions

1. Individual tax rate reductions.-- The individual tax rates for calendar years 1982 to 1983 would be adjusted so that the tax reductions resulting from the 1981 tax rate cuts are limited to $700 in 1982 and $1,400 in 1983 ($350 and $700, respectively, for married persons filing separate returns.)
2. Indexing. -- The indexing for inflation of the income tax brackets, personal exemption, and zero bracket amount (standard deduction), enacted in the 1981 tax bill, would be repealed.
3. Capital gains. -- The percentage of long-term capital gains included in taxable income would be increased from 40 percent to 50 percent, effective for gains realized after June 30, 1982. This would establish a maximum tax rate on capital gains of 35 percent for 1982 and 1983 and 25 percent thereafter.

II. Estate and Gift Tax Provisions

1. Carryover basis. -- The carryover basis provisions enacted in 1976 and repealed in 1980, would be restored for persons dying after December 31, 1982. Under present law, when a person inherits property, the basis of the assets, from which he computes depreciation and gain or loss, equals the fair market value of the asset at time of death (or on the alternate valuation date if elected on the decedent's estate tax return). As a result, any appreciation during the decedent's lifetime permanently escapes income taxation. Under carryover basis, the heir would use as his basis the basis of the asset in the hands of the decedent. However, taxpayers would be given a "fresh-start" under which the basis with respect to a decedent's property would be no lower than the fair market value of the assets on December 31, 1976.

2. Unified credit. -- Under the estate and gift taxes, the unified credit provides the equivalent of an exemption from the estate and gift taxes. The 1981 tax bill raised this exemption equivalent from $175,625 to $600,000, phased in over 6 years. These increases in the unified credit would be repealed.
3. Maximum estate and gift tax rate. -- The 1981 tax bill reduced the maximum estate tax rate from 70 percent to 50 percent, phased in over 4 years. This reduction, which only benefits estates valued over $2.7 million, would be repealed.
4. Exclusion for pensions and insurance. -- The estate tax exclusion for annuities would be capped at $500,000, for decendets dying after December 31, 1982.

III. Windfall Profit Tax Provision

1. Repeal of 1981 windfall profit tax cuts. -- The 1981 tax bill made three major reductions in the windfall profit tax. It reduced the tax rate on newly discovered oil from 30 percent to 15 percent, phased in over 5 years; it exempted stripper oil produced by independent producers; and it provided an exemption for royalty owners of up to 2 barrels per day in 1982-84 and 3 barrels per day thereafter. These windfall profit tax reductions would be repealed for oil produced after December 31, 1982.

IV. Business Tax Provisions

1. Leasing. -- The safe-harbor leasing provisions of the 1981 tax cuts, which enable taxpayers to use paper transactions to, in effect, buy and sell tax benefits, would be repealed effective February 20, 1982. However, leasing would be retained for mass transit commuting equipment.

2. Foreign tax credit. -- The foreign tax credit would be repealed, effective in 1983. Taxpayers would be allowed to deduct these payments instead of claiming tax credits.
3. Deferral on foreign income. -- Multinational corporations would be taxed currently on income from foreign subsidiaries, effective in 1983.
4. DISC. -- The tax deferral provisions for domestic international sales corporations (DISC) would be repealed, effective in 1983. Previously deferred DISC income would be recaptured over a 10-year period.
5. Reduction in investment credit. -- In order to scale back capital cost recovery provisions so that they are less generous than writing off the full cost of assets in the year the assets are placed in service (expensing), the investment tax credit would be reduced from 10 percent to 7 percent (from 6 percent to 4 percent for assets in the 3-year ACRS class), effective in 1983.
6. Limitation of graduated corporate tax rates to small corporations. -- Under present law, reduced tax rates apply to the first $100,000 of corporate taxable income. These low rates are available to large and small corporations. The bill would adjust corporate tax rates in order to phase out the tax reduction from the graduated rates as a corporation's taxable income rises from $100,000 to $200,000, effective in 1983.
7. Percentage depletion. -- Percentage depletion on oil and gas wells would be repealed, effective in 1983.
8. Intangible drilling costs. -- Taxpayers would not be allowed to expense intangible drilling costs on productive wells, effective in 1983.

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ESTIMATED REVENUE EFFECTS OF SELECTED PROPOSALS
(Requested by Mr. Downey)

	1932	1983	1984	1985	1986	1987
			Fiscal Years (Billions of Dollars)			
I. Individual income tax provisions						
1. Cap the 1982 and 1983 individual tax cuts at $700 per family	5.9	12.6	9.2	---	---	---
2. Repeal indexing provisions	---	---	---	9.8	25.6	42.9
3. Include 50 percent of long-term capital gains in taxable income	1/	1.2	2.5	2.5	2.6	2.8
II. Estate and gift tax provisions						
1. Carryover of basis	---	0.1	0.2	0.2	0.3	0.4
2. Unified credit	---	1.1	2.0	2.8	3.8	4.5
3. Maximum estate and gift tax rate	---	0.2	0.4	0.6	0.9	1.2
4. Exclusion for pensions and insurance	---	0.1	0.1	0.1	0.1	0.1
III. Windfall profit tax provision						
1. Repeal oil provisions enacted by ERTA	---	0.9	1.3	1.5	1.8	1.9
IV. Business tax provisions						
1. Repeal the leasing provisions enacted by ERTA	1.0	2.9	4.6	6.5	8.6	10.6
2. Repeal foreign tax credit 2/	---	3.2	6.5	7.1	7.4	8.2

1/ Less than $50 million

2/ Assuming that deferral has been repealed and that there is no behavioral change.

Estimated Revenue Effects of Selected Proposals--Downey

	Fiscal Years					
	1982	1983	1984	1985	1986	1987
	(Billions of Dollars)					
3. Repeal deferral on foreign income 3/	---	2.8	6.0	6.6	7.1	7.7
4. Repeal DISC (With 10-year recapture)	---	0.5	2.0	3.0	3.0	3.1
5. Reduce regular investment tax credit rate to 7 percent	---	3.6	8.1	9.4	10.8	12.3
6. Limit graduated rates to small corporations 4/	---	0.9	1.9	2.0	2.0	2.0
7. Repeal percentage depletion on oil and gas	---	0.8	1.5	1.7	2.0	2.1
8. Amortize IDC's over 10 years	---	3.5	7.7	8.4	9.0	9.6
TOTAL	6.9	34.4	54.0	62.2	85.0	109.4

3/ Assuming that foreign tax credit has been repealed and that there is no behavioral change.

4/ Corporations with less than $200,000 of taxable income.

OSBORNE
COMPUTER CORPORATION

26500 Corporate Avenue
Hayward, California 94545
415-887-8080

May 3, 1982

The Honorable Robert Dole
Chairman, Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Dole:

I am President of Osborne Computer Corporation, a manufacturer of portable microcomputers. In this capacity, I [redacted] write expressing my views with regard to proposed legislation that would increase the tax deductible contributions manufacturers of microcomputers could take when donating equipment to schools.

My primary concern is that the existing deductible contributions do not appear to have been well utilized by microcomputer manufacturers. An increase in the tax deductible contributions would appear to be of temporary assistance to a single company, Apple Computer Corporation, who, because of the timing in its company development cycle, is temporarily in a position to take advantage of such a break. This company has been in existence long enough to have established its credibility and finances. The industry is, however, rapidly moving into a far more competitive steady state situation, at which time it is far from clear that Apple Computer Corporation, or any other microcomputer manufacturer will be in any better position than companies at large to make educational contribution. Therefore, the proposed legislation would become a one-shot opportunity for a particular company to gain an advantage over potential competitors without the slightest guarantee that donations made now could or would establish a pattern for the future.

My concern, in a nut shell, is that the proposed legislation would have little long-term benefit to education.

The proposed bill has been criticized within the microcomputer industry as representing a device whereby Apple Computer Corporation intends to unload excess inventory at the government's expense. This may or may not be the case. Certainly it would be easy to assuage such fears by insuring that products donated were built at some point in the future using components that were purchased at some point hence, but even this assurance carries certain non-obvious implications. For example, microcomputer manufacturers, like all other manufacturers, offer low cost products by purchasing their supplies in very high volume. If, indeed, Apple Computer Corporation has a huge surplus of product sitting in inventory, then in order to deplete this inventory it must either stop building product for some months in the future, or it must find an alternative home for future products.

The Honorable Robert Dole
May 4, 1982
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If it stops building product for some months, it will severely damage its ability to buy low cost components and this would materially affect its competitive position in the future. It therefore makes sense for Apple to continue buying inventory, in order to keep the good faith (and low prices) established with its existing vendors. New product, which Apple donates under terms of the proposed bill, will eliminate the inventory, which Apple could continue to sell off to paying customers. Thus, its dilemma is neatly resolved. However, education would benefit only to the extent that surplus inventory exists at this point in time. Surely the purpose of charitable corporate giving is to provide for long-term benefits to society.

There is also the problem of fair market value, versus costs. The manner in which Apple Computer Corporation calculates manufacturing cost for its product needs to be examined. What, for example, is the amount of overhead Apple charges to direct materials and labor? This number must be very high, since small operators in the Far East have been building copies of Apple products and selling them for approximately half the retail price charged by Apple. Yet this is something no Far Eastern vendor could do with products manufactured by my company, since our burdened manufacturing costs are very low. Using my company's accounting rules I expect that we would establish a far lower manufacturing cost for hardware than reported by Apple Computer Corporation. In fact, it is possible that manufacturing costs reported by our accounting rules would generate a net profit if applied to Apple in conjunction with tax credits proposed by the new legislation. Once again, the "giving" aspect of charitable corporate deductions would be undermined.

I am opposed to the new legislation. I believe that a fair and equitable level of tax deductible contributions for educational donations should apply to all companies doing business in the USA. Manufacturers who want to make larger donations for altruistic purposes should be prepared to bear the cost burden themselves, without asking the American taxpayer to help foot the bill. The altruism would then be more impressive. I feel there is something a little bogus about donning the mantle of benefactor when, in fact, all the benefactor has done is channel tax dollars into his program of donations.

The Honorable Robert Dole
May 4, 1982
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I sincerely appreciate the opportunity you have presented to let me express my opinions before you. You may use my comments as you see fit, inserting them in the Congressional Record or your Committee Report if you choose.

Very truly yours,

Adam Osborne

Adam Osborne
President

AO:mdt
cc: Phil Morrison (5)

NORTHEAST UTILITIES
THE CONNECTICUT LIGHT AND POWER COMPANY
THE HARTFORD ELECTRIC LIGHT COMPANY
WESTERN MASSACHUSETTS ELECTRIC COMPANY
HOLYOKE WATER POWER COMPANY
NORTHEAST UTILITIES SERVICE COMPANY
NORTHEAST NUCLEAR ENERGY COMPANY

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HARTFORD, CONNECTICUT 06101
(203) 666-6911

1982 MAY 17 PM 12:41

LELAN F. SILLIN, JR.
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

May 10, 1982

The Honorable Robert Packwood
Chairman
Tax and Debt Management Subcommittee
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

I would like to commend you and your subcommittee for instituting a hearing on May 7 on Senator Danforth's bill S-1928, dealing with the tax treatment of the settlements of uranium contract litigation between Westinghouse and a number of electric utilities across the nation.

Among the utilities involved in the Westinghouse settlement were the participants in the Millstone Unit III nuclear plant, which is now under construction in Waterford, Connecticut. The operating companies of Northeast Utilities are the principal owners and builders of the plant and will operate it upon completion. The other participants are investor-owned and municipal electric utilities from all six New England states.

While the utility industry was represented in testimony at your hearing supporting this legislation, I would like to briefly summarize the interest of the Millstone participants and respectfully request that this letter be made a part of the hearing record.

The settlement between Westinghouse and the Millstone participants resulted in the owners achieving substantially the same position as if the supply contracts had been honored. The settlement of approximately $60 million provided that the participants would receive cash payments and goods and services at a discount and the future supply of uranium at a discount over a twenty-year period.

It is the participants' intent to apply the value of the settlement received in each of the twenty years against the cost of fuel obtained in those years. This accounting treatment will have the practical effect of reducing the fuel cost component to consumers of electricity produced by Millstone Unit III. The position taken by the Internal Revenue Service that the settlement is a taxable event resulting in full taxation in the year of settlement even though the benefits are spread over many years would increase the Millstone Unit III participants' tax liability by $25.7 million.

The Honorable Robert Packwood -2- May 10, 1982

The Millstone Unit III participants support S-1928 because we believe the proper tax treatment of the settlement is for the benefits to be taken into account as received and used to reduce the tax basis; (i.e., tax costs of uranium fuel). The amount of tax eventually to be paid is substantially the same under both the participants' and IRS's view. The difference is in the time of payment. S-1928 provides the discounts on goods and services are only to be reflected as price adjustments on the item to which they relate. The legislation would, therefore, leave the participants in the same tax position as they would have been had the original contract remained in effect, while providing some relief to the ratepayer from having to pay additional financing costs associated with raising the necessary funds for payment of the extra taxes.

I hope you will take these views into account and once again, thank you for your thoughtful consideration of this important matter.

Yours sincerely,

Lelan F. Sillin, Jr

LFS,Jr/gah

cc: The Honorable John H. Chafee
The Honorable Christopher J. Dodd
The Honorable George J. Mitchell
The Honorable Lowell P. Weicker, Jr.
The Honorable John C. Danforth

MasterCard International Inc.

AMY TOPIEL
Vice President
Counsel

(212) 974-5736

May 21, 1982

Robert E. Lighthizer, Esq.
Chief Counsel
Senate Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, DC 20510

[redacted]

Dear Mr. Lighthizer:

MasterCard International Incorporated ("MasterCard") is a membership corporation comprised of the over 12,000 financial institutions which issue and honor the familiar MasterCard credit card, MasterCard II debit card and preferred MasterCard cards. The credit card provides its customers with the opportunity to purchase goods or services or obtain cash advances and defer payment therefor. Payment can be made by either paying for the transactions previously charged in one, full payment or by paying a portion (above a minimum amount) and paying for the balance over an indefinite period of time. Depending on the program of the MasterCard member, interest fees may be charged to the cardholder at any time after the purchase has been effected.

In view of the thrust of S.2214 to eliminate the tax deductibility of credit card interest, MasterCard opposes S.2214 and presents below its comments for your consideration and for inclusion in the hearing record.

The apparent purpose of S.2214 in eliminating the tax deduction for interest paid on credit card debt is to remove what the sponsors see as an incentive for consumers to incur debt. Their reasoning is that by incurring debt the supply of capital is diminished, interest rates are forced up and inflation results. Using this thinking, the solution is said to be to disallow the deduction, reduce the incentive to incur debt which will increase the capital supply, thus resulting in lowered interest rates and controlled inflation. While we share the concern of S.2214's sponsors who seek to reduce inflationary pressures, we submit that

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elimination of the interest deduction on certain forms of consumer credit will be a terrible disservice to consumers, will have virtually no impact on the rate of inflation and, instead will serve to further worsen the state of this nation's economic condition.

S.2214 will particularly disservice those consumers who do not have the ability to make purchases with cash. These people rely on the card to take advantage of special sales in order to save money and to pay for emergency needs where money would otherwise not be available to them. By disallowing the deductibility of the interest charges, S.2214 would penalize these individuals for borrowing money to meet their special needs by forcing them to pay for the full cost of the finance charges. In this regard, we take issue with the rationale for condoning this penalization, to wit:

> "The deduction for consumer interest expense [also] discriminates against lower income groups. This deduction effectively cuts in half the cost of debt for the taxpayer in the fifty percent tax bracket, while lower income taxpayers who do not itemize pay the full cost. Thus, for credit card purchases at 18% interest, high income individuals pay 9% while those with low incomes pay the full 18%. It is high time for this unfair, discriminatory and economically unsound provision to be eliminated."[1]

While it is true that people who are in the fifty percent bracket are advantaged in borrowing money more than those who are not, it is also true that there are many people in this country who are not in the fifty percent bracket and who look to the interest deduction in itemizing expenses as a set off to allow them to purchase goods and services and maintain the kind of quality of life of which this country is proud. In our most recent study[2], 40% of bankcard holders had a household income between $10,000-$19,000 (40% had incomes over $20,000 but we do not have a breakout of how many earn $50,000 or more). It is these people -- those earning $10,000-$25,000 -- who utilize the credit card to purchase items when necessary and where cash is not readily available to them and who will continue to use the card even if the deduction is eliminated. It is also these people who are not earning especially high incomes but who are relying on the deduction of interest to help them cut their living expenses to maintain themselves in inflationary times. Although these individuals are not receiving a one-half tax break, they are receiving some form of a break. And, in these difficult times, some economic benefit is better than none.

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[1] Dear Colleague letter.
[2] 1977

Moreover, the fact that people in the fifty percent bracket are benefited more than less financially fortunate people by the deduction is a statement equally applicable to every deduction and credit contained within the Internal Revenue Code. Given the reality of the Code, there is no reason to do away with this one deduction while maintaining all other tax deductions and credits. If it is "high time" to do away with this interest deduction because it is "unfair, discriminatory and economically unsound" as benefiting the rich more than others, we submit it is likewise "high time" to do away with all deductions and credits and rework the entire tax scheme into a simple income tax schedule. Yet, this is not what is being suggested.

Based on this (fallacious) rationale it would certainly be "unfair, discriminatory and unsound" to allow businesses the interest deduction but to disallow it for consumers, particularly since there are as many dollars involved in commercial loans as there are in the types of consumer installment debt specified in S.2214.

It would appear that the only rationale for distinguishing between types of credit is that commercial borrowings are viewed by the sponsors as stimulating the economy and that the home and automobile industries are suffering and are considered to need special protection. We suppose it is felt that borrowings in these areas should not be discouraged. The flaw in this rationale is its myopic focus. Taking alone the distinction between types of consumer credit, we strongly suggest that this line of thinking is incorrect in assuming that the health of only home and automobile industries is related to the well being of the economy. Clearly, the health of all businesses impact on the nation's economic condition. To the extent that small and medium-sized retail businesses have learned to depend on credit card sales to meet their expenses and achieve profits, and to the extent these sales are discouraged by S.2214, we may well expect to see the deterioration of these retail businesses. The result will be a loss of service, convenience and competition in the market to the disadvantage of the consuming public. If this is the result, as anticipated, economic conditions in this country will deteriorate. A worsened economy surely will not yield a better market for the home and automobile industries and, more importantly, the result will work against the very purpose of S.2214: to improve the economy.

In addition, the distinction made by S.2214 between types of consumer credit is artifical and illogical, especially as to credit cards, because consumers may use their credit cards, for example, to place a deposit on a car. Thus, this bill would discourage some forms of car financing but not others, for no apparent reason. Similarly, credit cardholders can, in some areas of the country, agree to obtain a line of credit secured by the equity in their home, not unlike a second mortgage (of which interest would be deductible under S.2214). And, again, consumers may place a deposit on a home using their credit card. The disparity in treatment is inexplicable and, while we have no statistics on the extent to which cards are so used, they are not uncommon and serve to assist these industries in providing a convenient and ready source of purchasing power for consumers.

Moreover, it cannot be over emphasized that the action of S.2214 will have virtually no impact on inflation. This is true, among other reasons, first, because there is no evidence that doing away with the deduction for interest will curtail consumer credit borrowings. As mentioned earlier, consumer borrowings are a fact of life because they help consumers maintain a decent life style in difficult economic times. Consumers do not borrow money merely to deduct the interest. Secondly, consumer credit, exclusive of credit on homes and automobiles, comprises only 15 percent of all credit extended to consumers. According to the Federal Reserve's own December, 1981 Report, $206,944,000 was borrowed for consumer installment purchases, $126,431,000 for automobiles and $1,018,472,000, for homes. Thus, even if S.2214's programs were to be successful in curtailing non-car and non-home related consumer credit, it would have such an insignificant impact on consumer borrowings generally as to be ineffectual on the supply of capital, the rate of interest and, in turn, on the inflation rate. This conclusion can only be reinforced vis-a-vis the continuance of the interest deduction for businesses which involves at least as many dollars as the total consumer indebtedness. While we are not suggesting that the interest deduction be eliminated for all forms of indebtedness, we clearly feel that there is no reason for, or national benefit to be derived by, singling out credit card and other consumer indebtedness for this treatment.

It is also of historical interest to note that the deduction for consumer indebtedness was first included in this nation's original 1913 Internal Revenue Code and has remained ever since. It has been an important part of our nation's buying patterns for over 60 years. And, more importantly, while the sponsors of S.2214 have provided no evidence that negating the deduction for consumer credit interest will have any impact whatsoever on the inflation rate, it is clear that for the period that this provision has existed, there has been no problem with inflation. We submit that this fact, combined with an understanding of how relatively small are the dollars involved in the targeted consumer debts, indicates that inflation is not impacted by this provision but, rather, by some other cause or causes which deserve more attention from this nation's policymakers.

Finally, we propose that the most efficacious way to encourage personal savings is not by indirect, disincentives against borrowings but, rather, by the establishment of direct incentives to saving. In each of the Western world countries which boast a higher savings rate than the United States, positive actions have been established to significantly reduce the tax imposed on savings and stock investments. For example, in Japan, there is a lower taxation for shareholders owning stock and receiving dividends. In the United Kingdom and Germany, there are lower maximum marginal tax rates. While S.2214 would offer additional tax relief on earned interest, the relief is directed at only net interest income (interest expenses less interest income) and, in any event, is a small deduction requiring the major portion of the net interest income to be taxed at the full tax rate, offering a minimal incentive to consumers to save.

Experts seem to agree that the fall in personal savings is due to a flare-up in inflation. Because of the steady rise in the cost of living since the 1970's consumers have realized that it is economically more beneficial to accumulate goods than to save their money. This would not be as true if consumers could earn a reasonable rate of return on their money from financial institutions with whom they do business and who they trust as insured institutions to safeguard their money. Unfortunately, federal law severely restricts traditional financial institutions from paying consumers a market rate of interest and thus, offers no realistic facility to consumers to put their money into savings in an inflationary condition. In fact, the staggering growth of money market funds indicates a consumer willingness to save, and not spend, money if the earnings on that savings can keep pace with inflation.

Accordingly, for the reasons stated above MasterCard urges that S.2214, as it relates to eliminating the deduction for credit card interest charges, be voted down.

Thank you for considering our views.

Very truly yours,

Amy Popiel/ia3

SEARS HOMAN AND ARTHINGTON
Employes' Credit Union

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May 24, 1982

Mr. Robert Lightizer, Chief Council
Senate Finance Committee
United States Senate
Washington, D.C. 20210

Dear Mr. Lightizer:

You have before you a bill known as the Savings and Investment Incentitives Act. I believe this bill to be in the best interest of the American people.

For over twenty years, we have put our values on spending rather than on saving. Part of the American economic problem lies in this philosophy. We give tax deductions to people who borrow and tax those who save and invest.

One of the reasons our founding fathers fought the Revolutionary War was for economic freedom. The freedom to work and earn money and to save without being taxed. The slogan "Over Taxation" has rang from 1776 to 1982.

I am in the financial field and am concerned about that field. Every day we learn from the media about S&Ls, banks, credit unions, etc. being in financial trouble. We see where Americans earn more and yet are among the worst savers. Why? Our present philosophy is: "Borrow - it is tax deductable. Save or invest - it is taxed." And, until this philosophy is reversed, our economic problems will not be solved. However, if it is reversed, we will see an upserge in savings and investments and people borrowing and using credit wiser. They also will save in order to purchase later. Thus, Americans will be better savers.

Right now the American people are subsidising the financial institutions of this land. From loans to credit cards, the interest is tax deductable, therefore creating a type of subsidy. This subsidy helps keep interest rates high. If financial institutions had more money, they could lend more which would result in falling interest rates. Home loans, auto loans, etc. would all be easier to get and at a rate substancially below what they are now.

I believe it is imperative that we change our present philosophy. That is why I support the Savings and Investment Incentitives Act.

I wish my comments to be made part of the May 7, 1982 record.

Sincerely,

Charles O. Gneuhs, President/Chief Operating Officer

COG/pkg

General Aviation
Manufacturers Association

Suite 517
1025 Connecticut Ave., N W
Washington, D C. 20036
(202) 296-6540

STATEMENT OF
EDWARD W. STIMPSON, PRESIDENT
GENERAL AVIATION MANUFACTURERS ASSOCIATION
BEFORE THE
SENATE FINANCE COMMITTEE
JOINT SUBCOMMITTEE HEARING
ON
S.2214
MAY 7, 1982

Mr. Chairman, I appreciate the opportunity to share with you and the Committee the views of the General Aviation Manufacturers Association on S.2214. Our member companies manufacture the vast majority of general aviation aircraft, engines, avionics, and component parts produced in the United States.

In these depressed economic times, when huge budget deficits and high interest rates are taking a significant toll in business failures and record unemployment rates, it is hard to quarrel with prudent proposals to promote private savings and investment, reduce the demand for credit and, hence, the upward pressure on interest rates, and increase tax revenues. That is what this bill portends to do, and it is commendable.

It is interesting to note, however, that the authors of the bill recognize some basic facts of life: that Americans of virtually every economic strata own an automobile, and the vast majority of them buy them on credit terms. It is indeed appropriate that the existing privilege of deducting the interest expense of such purchases on their income tax returns be retained. One might question the number of taxpayers who exercise this privilege, but without it, automobile sales would unquestionably suffer, further damaging a depressed industry.

Similarly, the denial of tax deductions for home mortgage interest payments would have an even more damaging effect on our nation's housing industry. The American dream of owning one's home would vanish for all but the very wealthy. The wisdom of this exemption is self-evident.

But many Americans also dream of owning their own airplane. Without the existing interest expense deduction -- which would be eliminated with the passage of S.2214 -- these dreams would also vanish. Moreover, it would have a damaging effect on the general aviation industry, a severely depressed national asset currently suffering from the lowest sales levels in twenty years. Production facilities have been closed and unemployment in the industry is close to forty percent. Jobless workers number in the tens of thousands, creating increased demands for unemployment benefits and significant reductions in tax revenues. Enactment of S.2214 as proposed would place the private purchase of an airplane out of reach of most Americans, thereby frustrating the growth of an industry which has played such a key role in meeting the transportation needs of this nation.

In all candor, Mr. Chairman, very few individuals are buying airplanes for their personal use today. This is due largely to economic uncertainties and high interest rates. However, as the economy recovers, we would expect the demand for airplanes -- which is still high today -- to translate into increased sales, production, jobs and revenue. But this resurgence within the industry would be slowed without the tax incentives for individuals to procure their own planes.

We urge this Committee to be mindful of the harmful effects S.2214 could have on an ailing industry and those countless Americans who still dream of owning their own airplanes.

National Association
of Real Estate
Investment Trusts, Inc.

May 21, 1982

The Honorable John H. Chafee
Subcommittee on Savings,
Pensions & Investment Policy
Committee on Finance
2227 Dirksen Senate Office Bldg.
Washington, D. C. 20510

The Honorable Bob Packwood
Subcommittee on Taxation
& Debt Management
Committee on Finance
2227 Dirksen Senate Office Bldg.
Washington, D. C. 20510

Dear Senators Chafee and Packwood:

We are writing to request that the following statement be placed in the record relating to S.2214, a bill to amend the Internal Revenue Code of 1954 ("Code") to provide for a partial dividend and interest exclusion and to eliminate the consumer interest deduction. The statement expresses the concern of the National Association of Real Estate Investment Trusts, Inc. ("NAREIT") and the REIT industry* regarding the portion of the bill that prescribes the treatment of REIT dividends for purposes of the dividend exclusion. Although the industry generally supports the exclusion as a valuable incentive for investment and capital formation, it is our opinion that in the context of REIT shareholders, the legislation would actually prove to have a detrimental effect obviously contrary to the legislative intent.

Subsections (a) and (c)(5) of section 1 of S.2214 would essentially reenact sections 116 and 857(c) of the Code as those provisions were in effect for taxable years beginning after December 31, 1980 and before January 1, 1981. As added by the Crude Oil Windfall Profit Tax Act of 1980, those provisions operated in conjunction to permit REIT shareholders to exclude from income dividends received from the REIT to the extent attributable to certain categories of interest income realized by the REIT. Subject to some modification proposed by S.2214, section 116(c)(1) defined the qualified interest income to include items such as interest received on (1) deposits placed in banking and "thrift" institutions, (2) registered debt of domestic corporations, and (3) federal, state and local government obligations. Congress extended this treatment to REIT shareholders in recognition of the

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*NAREIT has among its membership 75 "tax qualified" real estate investment trusts, with assets of $5.3 billion, comprising 80 percent of the assets of all qualified REITs. Other NAREIT members include some 180 non-qualified REITs, leading law and accounting firms, and other organizations actively involved in the REIT industry.

1101 Seventeenth Street, N.W., Suite 700, Washington, D.C. 20036-4731 202/785-8717

Senators Chafee and Packwood
Page 2
May 21, 1982

fact that dividends of conduit entities such as REITs merely represent the passthrough of specific items of income earned by those entities. (Report of the Committee of Conference, H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 157 (1980)).

Consistent with their mandate set forth in the body of law associated with Section 856 of the Code, REITs derive substantially all of their income from real estate investment activity. They typically earn insignificant amounts of interest income in the categories described in section 116, instead deriving most of their interest income on real estate loans.

Given the omission of mortgage interest from section 116, the partial dividend exclusion for REIT shareholders having taxable years beginning in 1981 has proven to be an illusory investment incentive. In fact, the cost and administrative burden to the REIT attributable to the accounting for and reporting of eligible interest has effectively negated the limited tax savings realized by shareholders. As effective in 1981 and in the form proposed in S.2214, sections 116 and 857(c) have a detrimental effect that is clearly inconsistent with the intent of encouraging capital formation and expending investment incentives.

These objectives would be served in some cases by permitting REIT dividends to be eligible for the exclusion taking into account mortgage interest as qualifying interest. Mandatory application of such a provision would, however, continue the disadvantageous circumstance for shareholders of those REITs that derive most of their income in the form of rents or other sources not in the nature of interest.

Accordingly, we urge your Subcommittees, in considering S.2214, to refrain from enacting a partial dividend exclusion that would apply to REIT dividends to the extent of qualifying interest income realized by the REIT. Specifically, NAREIT opposes enactment of the special rule of proposed Code section 116(c)(2) (relating to dividends of real estate investment trusts) as set forth in section 1(a) of S.2214. Furthermore, NAREIT opposes enactment of proposed Code section 857(c) (setting forth limitations on REIT dividends) as set forth in section 1(c)(5) of S.2214.

We would also take this opportunity to urge that Congress amend or repeal Code sections 128 and 857(c) as added and amended by sections 302(a) and 302(c)(2) and (5) of the Economic Recovery Tax Act of 1981. Designated for repeal by section 1(b) of S.2214 and not effective until taxable years beginning after December 31, 1984, sections 128 and 857(c) would provide an interest exclusion for eligible portions of REIT distributions in a manner analogous to the proposed dividend exclusion. Once it is effective, the interest exclusion will have the same adverse effects described above with respect to the dividend exclusion. Thus, NAREIT would support section 1(b) of S.2214 as it proposed repeal of sections 302(a) and (c) of the Economic Recovery Tax Act of 1981.

As an industry, we support the efforts of your Subcommittee to enhance capital formation and expand investment incentives. We would welcome any opportunity to be of service in that endeavor.

Sincerely,

Allan H. Glidden

Allan H. Glidden
President

AHG:TR:jd

STATEMENT OF THE

NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

AND

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

MAY 21, 1982

The National Association of Life Underwriters (NALU) is a voluntary membership organization with more than 1,000 state and local affiliated associations whose individual membership consists of over 130,000 life insurance agents, general agents and managers residing and doing business in virtually every community in the country. We would like to register general opposition to the elimination of the tax deductions for consumer interest contemplated by S. 2214, and express particular concern with the proposed elimination of the interest deduction on life insurance policy loans. The elimination of the latter deduction might in particular produce results running counter to whatever beneficial effects might be realized from enactment of the bill itself.

We understand that, under S. 2214, a deduction would be allowed only for certain types of interest ("qualified interest"). These would include interest incurred in 1) carrying on a trade or business, 2) acquiring, constructing, reconstructing or rehabilitating a dwelling unit, 3) acquiring a passenger automobile, and 4) paying higher education expenses of the taxpayer or his dependent.

In a statement accompanying introduction of S. 2214, Senator Schmitt said the bill "is designed to provide a real and effective incentive for the public to increase its rate of personal saving and investment." The Senator said S. 2214 "would also have a positive impact on our current high rates of interest by increasing the available pool of national capital."

Thus the bill, as characterized in its introduction, has two chief objectives:

1. To increase personal saving and investment; and
2. To increase available capital.

Whether and to what extent these highly commendable results would in fact be accomplished by the general elimination of the tax deduction for consumer interest expense is obviously open to question. We believe, as a general proposition, that enactment of a measure containing these restrictions is unwarranted.

Desirable as Section 1 of S. 2214 might appear to be, in that it would increase the exclusion from income for interest and dividends, NALU is opposed to Section 2, which would generally eliminate the deduction for consumer interest, for the following reasons:

1. Elimination of the consumer credit interest deduction would discriminate against many taxpayers. According to Senator Schmitt's introductory remarks of March 16, 1982, the current tax code "discriminates against lower income groups while giving high income groups a tax break to make borrowing less expensive." Instead of alleviating discrimination, Section 2 of S. 2214 would intensify discrimination against people in lower to middle income tax brackets who must use credit to purchase such things as clothing and other necessaries and can now deduct the interest on loans made for those purposes. In testimony received by your committees it has been shown that

25% of all taxpayers with adjusted gross income of between $10,000 and $20,000 itemize deductions. More than 50% of taxpayers with adjusted gross income between $20,000 and $25,000 itemize their deductions. Clearly this interest deduction is important to many lower and middle income taxpayers, many of whom must borrow for necessaries.

2. Elimination of the consumer interest deduction would unfairly discriminate against certain categories of borrowing and favor others. There is no cogent reason why housing and automobile loans should continue to enjoy an interest deduction and not categories of equal importance, such as clothing. Under Section 2 a purchaser of a home including appliances would be entitled to an interest deduction, but not one who purchases such appliances separately.

3. Section 2 of S. 2214 would have the effect of increasing taxes for many individual taxpayers. In the Economic Recovery Tax Act of 1981 (ERTA), enacted into law less than one year ago, the Congress cut taxes on the premise that higher marginal tax rates stifled productivity and economic growth. S. 2214 would have the obvious effect of increasing taxes for many people. The beneficial effects of ERTA would thus be diminished. What amounted to tax reduction in 1981 would only mean higher taxes for many people in 1982.

4. Because of the additional interest and dividend exemptions provided for in Section 1 of the bill, S. 2214 would produce a revenue loss for the first two years, at a

time of skyrocketing budget deficits. According to an analysis prepared by the Joint Committee on Taxation it is estimated that the bill would reduce fiscal year receipts by $160 million in 1982 and $755 million in 1983.

5. No evidence has been presented to substantiate the claim that consumer demand has been excessive or has contributed to high interest rates. According to Federal Reserve Board statistics, consumer borrowing has remained at approximately 5.5% of total U. S. borrowings over the past ten years. Thus a measure such as S. 2214 would not seem necessary to discourage borrowing.

6. Section 2 of S. 2214 is administratively unsound and could be circumvented by characterizing personal loans as mortgages, or loans to carry on a trade or business, for example, thereby defeating the intent of the bill. Should this bill become law, individuals could seek to convert personal loans (not entitled to an interest deduction) into mortgages or may seek personal loans under the protective cloak of higher education.

Credit disintermediation would occur. For example, a taxpayer with limited cash on hand who is faced with the necessity of putting a new roof on his house and the desire for the annual family vacation would normally use the cash to fix the roof and finance all or part of the vacation by a loan or through the use of various credit cards. If Section 2 of S. 2214 were to be enacted, however, this same taxpayer could well borrow to rehabilitate his dwelling unit in order to deduct the interest and use his limited cash for the vacation. Result? Borrowing has been restructured but by no means discouraged. Similar examples could be constructed using the other exceptions to elimination of the consumer interest deduction.

Adverse Effects of S. 2214 on Life Insurance

If, however, a bill such as S. 2214 is to become law in spite of its apparent shortcomings, then as life insurance people we feel justified in saying that the elimination of the deductibility of the interest paid on life insurance policy loans might not only fail to produce the beneficial results intended by S. 2214, but might indeed serve to intensify the very problems the bill is designed to solve.

It is doubtful whether elimination of the life insurance policy loan interest deduction would increase personal savings, as S. 2214 would purport to have it do. Elimination of this deduction would probably in fact serve the opposite purpose, that of decreasing personal savings.

One of the many attractive features of cash value life insurance is the accumulation of policy values that may be borrowed against by the policyholder. The attraction of this particular feature of the policy is further enhanced by the deductibility of interest paid on a loan against those policy values. These aspects of the cash value life insurance contract are pointed to by life insurance agents during the sales process, and it is fair to say that the presence of these features is a significant and perhaps determining consideration in many decisions to purchase life insurance.

If by enactment of S. 2214 this life insurance policy benefit is rendered less attractive, then to the extent that new life insurance sales are thereby deterred, personal saving will be inhibited rather than spurred.

It might be argued in this regard that elimination of the interest deduction for policy loans would tend to discourage policy borrowing and thus at least perserve capital already formed. But if any governmental inhibition against borrowing against cash values is necessary to preserve available capital, such inhibition is even now being installed, through the gradual enactment in the states of the National Association of Insurance Commissioners' Model Variable Policy Loan Interest Rate Bill, which substitutes flexible and more realistic policy loan interest rates for the very low policy loan interest rates of 5, 6, or 8% that have been traditionally permissible under state law. In just two years since its promulgation by the Insurance Commissioners, the new law has been adopted in 31 states. It is reasonably to be anticipated that this new law will have a natural dampening effect on policy loans, despite the continued availability of the federal income tax deduction for interest paid on those loans.

Disallowance of the interest deduction on life insurance policy loans as a means of discouraging policyholder borrowing is unnecessary for another and perhaps more important reason. Life insurance purchase arrangements are virtually always entered into with the purpose of long-term saving rather than spending in mind. Thus normal consumer impulses which in other purchase situations might be operative need not be curbed or reversed in life insurance transactions by methods such as those contained in S. 2214. If the vast majority of eligible life insurance policies were in fact borrowed against by consumer/policyholders, then it might be argued that S. 2214 is needed to limit and discourage the practice.

However, available life insurance industry statistics reveal that of all policies in force in 1980 against which loans might have been made, only 20% of those policies were in fact the subject of loans. This already low percentage must be reduced even further in recognition of the substantial portion of this limited borrowing that must be attributed to business purposes, a deduction which would not be affected by enactment of S. 2214 in any event. We believe the low percentage of policies actually borrowed against for personal rather than business reasons attests that, even in times of high and volatile interest rates, people tend to borrow against life insurance policies only as a last resort, and do not need the additional discouragement of an S. 2214 as a disincentive to borrow.

Completely aside from the buildup of policy loan values, the very purchase of life insurance--unlike the purchase of most consumer goods--contributes to capital formation. The long-term nature of the life insurance contract requires the setting aside of policy reserves, which are in turn available for investment in the economy. In this manner, the life insurance industry now has well over $300 billion so invested, and provides the Nation's largest pool of funds for capital investment. Once again, elimination of salient points in favor of life insurance purchases, such as the policy loan interest deduction, would have a deterrent effect on life insurance purchases and thus on the creation of capital.

When the Congress has had occasion to consider the matter of borrowing against policy values in the past, the importance of the deductibility of interest on policy loans has been recognized and preserved. For example, in connection with the Revenue Act of 1964, the House-adopted Report of the Committee on Ways and Means [H. Rep. No. 749, 88th Cong., 1st Sess., Sept. 13, 1963] said that

> "Your Committee recognizes...the importance of being able to borrow on insurance policies; and, therefore, while adopting a provision designed at minimizing the sale of insurance as a tax-saving device, it has been careful...to provide for the retention of rights to borrow on insurance for other than tax-saving purposes <u>without the loss of the interest deduction</u>." (Emphasis added).

To the extent that the potential interest deduction on policy loans is preserved as a sales technique and an incentive to purchase life insurance, the aggregate result will be stimulation of capital formation rather than encouragement of personal consumption. The key to understanding this critical point is that the availability of the policy loan option and the accompanying interest deduction provides an important financial harbor wherein the life insurance policyholder is able to gain access to capital without surrendering the valuable life insurance protection afforded him by the policy. While such access to funds is of great value from the standpoint of planning for financial emergencies, in practice the use of policy loans for ordinary consumer purchases is infrequent due to the unique long-range commitment to life insurance protection made by most purchasers.

The purchase of a life insurance policy is itself a commitment to the regular contribution to available capital and systematic personal saving as opposed to spending. Whereas in many commercial transactions personal consumption occurs as an alternative to personal saving, and depletion of capital and reduced personal saving are the inevitable concomitant, in life insurance accumulation of capital through a regular course of saving is the rule. Clearly, elimination of any particular interest deduction would seem justified under the philosophy of S. 2214 only after the allowance of that deduction is tested and found to inhibit increased personal saving or capital formation.

NALU would ask your Subcommittees to consider the more than $300 billion that the life insurance industry has invested in long-term commitments in the American economy as probative evidence that one of the surest ways to increase available capital is to do everything possible to encourage, rather than discourage, the purchase of life insurance.

NALU urges you, first of all, to reject the general disallowances of interest deductions proposed in S. 2214, or, failing in that, to recognize the special arguments we have made with respect to life insurance and at least decide in favor of preserving the tax deduction for interest paid on life insurance policy loans.

STATEMENT BY AMERICAN RECREATION COALITION

ON S.2214 REGARDING CONSUMER LOAN INTEREST DEDUCTIBILITY

May 21, 1982

We are pleased to submit our comments on S.2214, particularly regarding Section 2, which would eliminate the deductibility of interest on many consumer loans. A large number of the organizations comprising the American Recreation Coalition (ARC) are dependent upon the sale and use of durable goods which are often financed and which would be affected by this provision.

ARC was formed three years ago to provide a unified voice for recreation in America. Our membership now includes approximately 80 national and regional organizations representing a broad array of recreational activities and recreation industries, from American Youth Hostels Inc. to the International Snowmobile Industry Association; from the American Horse Council to the National Marine Manufacturers Association; from the Experimental Aircraft Association to the International Association of Amusement Parks and Attractions.

The American Recreation Coalition is most supportive of actions which will spur productivity in the workplace. We understand this to be the primary goal of S.2214, a goal it seeks to achieve through incentives to saving and investment. We believe that a variety of factors impact productivity, not merely capital investment. We believe, for example, that the overall quality of a worker's lifestyle greatly influences his or her actions. Recreational activities play a large and growing role in defining an individual's perceived quality of life, so that we believe that facilitation of recreation as well as encouragement of capital investment are essential to growth in productivity.

Unfortunately, Section 2 of S.2214 will inhibit recreation by imposing financial and psychological disincentives to the purchase of recreational items ranging from pools to boats, RV's to motorcycles, snowmobiles to aircraft. Section 2 would reverse a consistent ingredient of U.S. tax policy for some 70 years, including periods of remarkable growth in productivity and parallel tremendous growth in recreation activities. We do not believe that adequate cause exists for this major revision to tax policy in light of what we believe may prove to be a major adverse impact on consumer recreation equipment sales.

We further offer the following comments:

- Any decrease in sales of boats, RV's, motorcycles, pools and other recreational items will produce job lay-offs in those industries and adversely affect the economy. Ironically, these lost jobs would be essentially identical in skills and functions to those targeted for protection in the housing and automobile industries;
- The protected treatment provided to the housing and automobile industries under the bill is blatantly inequitable;
- The denial of deductions retroactively could create financial difficulties for middle-income Americans who have financed RV's, boats, pools and other products for periods of up to ten years at today's high interest rates;
- Aside from the new financial impact, which will be felt by those taxpayers who already shoulder the principal burden of taxation in this country, the measure will have an adverse psychological impact on the sales climate, adding to the burden sellers of recreational products now face;
- The denial of consumer loan interest deductibility will likely lead many higher income individuals to rearrange their borrowing

patterns, assuring interest deductibility as business costs. Middle-income families will be most seriously impacted, for they will be less sophisticated in their tax planning;

- The definitions used for automobiles and dwelling units, and the preferred treatment accorded those items, will influence consumer choices in ways perhaps not fully recognized. For example, fixed second homes would become markedly more attractive than motorhomes used as second homes; fuel-efficient commuting via motorcycle would be discouraged;
- The current language would allow the owner of an expensive foreign automobile to deduct interest payments while a middle-income family buying a travel trailer to visit America's national parks economically would be forced to pay all financing costs on the trailer.

We believe that S.2214, while sound in intent, will not strike a clear blow for improved productivity in America. The additional revenue which might accrue to the treasury through enactment of Section 2 should not overshadow the potential consequences of this significant shift in policy and its impact on American lifestyles.

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