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COMPETITIVENESS AND LONG-TERM TAX POLICY

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BEFORE THE

SUBCOMMITTEE ON TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

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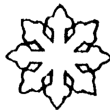

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COMPETITIVENESS AND LONG-TERM TAX POLICY

THURSDAY, FEBRUARY 6, 1992

U.S. SENATE,
SUBCOMMITTEE ON TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:10 p.m., in room SD-215, Dirksen Senate Office Building, Hon. David L. Boren (chairman of the subcommittee) presiding.

Also present: Senators Roth and Danforth.

[The press release announcing the hearing follows:]

[Press Release No. H-4, Jan. 30, 1992]

SUBCOMMITTEE TO FOCUS ON COMPETITIVENESS, LONG-TERM TAX POLICY; BOREN WANTS TO AVOID QUICK FIX

WASHINGTON, DC—Senator David L. Boren, Chairman of the Finance Subcommittee on Taxation, Thursday announced a hearing on competitiveness and long-term tax policy.

The hearing will be at *2 p.m. Thursday, February 6, 1992* in Room SD-215 of the Dirksen Senate Office Building.

Boren (D., Okla.) said the hearing will focus on the tax system's effect on the cost of capital and the international competitiveness of U.S. business.

"As we work on a tax bill that attempts to provide economic stimulus and taxpayer relief in the short term, we must not sacrifice our long-term goals for a quick fix," Boren said.

"Our objectives must be to lower the cost of capital in this country and to enhance our ability to compete effectively in the international marketplace," Boren said.

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BOREN. I expect other colleagues will be joining us, but I think in light of the valuable time of our witnesses, it would be appropriate for us to go ahead and commence.

At the outset let me welcome my colleagues and distinguished panelists and open this hearing on long-term tax policy and the tax system's effect on the cost of capital and the ability of U.S. businesses to compete internationally.

Today we embark on what I hope will be a series of hearings before the Subcommittee on Tax Policy that will focus on the long-range objectives which should guide any of our efforts to reform the present tax system.

Such a structural analysis is always timely and important, because we must be mindful of long-range planning goals as we determine the proper direction for legislative change.

These hearings and the ideas that they engender have become particularly crucial in the past few days. During the next several weeks, the Congress and the President will be working together to craft an economic growth package which is certain to include tax incentives and other changes in the Tax Code.

In this atmosphere of preoccupation with short-term problems and solutions, it is imperative that we act in ways that are consistent with long-range objectives.

Thus, while this hearing is not intended to provide a forum for a discussion of the specific proposals currently before the Congress, this context necessary affects our proceedings today.

I have never believed that the Tax Code can be or, for that matter, should be neutral in an economic sense. The tax system inevitably will encourage some types of economic behavior, while discouraging other activities because its provisions interact with the distribution of limited resources in the economy.

This economic fact of life is not disturbing. Indeed, Congress has the responsibility to use the legislative tools at its disposal to guide the economy and the country in ways that will benefit our citizens. The Tax Code is one of the most powerful of these tools.

Given the impossibility of neutrality, we must be very aware of the tax system's effect on investment and productivity—two key factors in economic growth. Employment, as well, is impacted by the Tax Code, and this country's ability to remain a world leader.

I have become increasingly convinced, however, that our tax system actually discourages investment and actively impedes our ability to compete in the world marketplace.

For example, it has become apparent that the cost of capital for U.S. businesses is substantially increased because of the tax burden on capital assets. The increased cost of capital has, in turn, decreased our ability to compete against our major trading partners.

A study by Arthur Anderson demonstrated that after 5 years a U.S. corporation paying the regular corporate tax recovers 77 percent of the original cost of a factory robot. And a U.S. corporation paying the alternative minimum tax recovers only 37 percent of that cost in the first 5 years.

This last figure may well be the more relevant one in light of estimates that about one-half of this Nation's businesses are AMT payers, or were AMT payers in 1991.

These figures compare unfavorably with capital recovery rates in other countries. We mention again our producers are recovering 30 percent of their investment in 5 years under our Tax Code, while businesses in Korea will recover 106 percent of their capital costs for such equipment during that same 5 years, and German companies will recover over 81 percent.

Obviously, we are not going to be in some forms of business and production if we continue to have these kinds of disadvantages caused by our tax system.

It is clear that we must think internationally when we consider tax policy. We cannot afford to write our tax policy in a vacuum. We must consider how it relates to the tax policy of other nations with whom we must compete in the world marketplace.

This hearing allows us the opportunity to explore those issues with the expert panelists present with us today. Professors Feld-

stein and Shoven have produced a wealth of scholarship on these issues and are here to share their innovative ideas and perspectives with us.

In addition, we will talk with four business leaders who participate actively both in the domestic economy and in the international markets. They are aware on a day-to-day level that the Tax Code influences their business decisions and their ability to compete with their foreign competitors.

By focusing on these issues from a theoretical and practical perspective, we can begin the process of determining the proper long-term goals for our tax system and we can start to construct a Tax Code that better serves those objectives.

So, we appreciate very much our witnesses being with us today. These are issues which I hope will frame our debate on tax policy as we examine what needs to be done in the short run, especially in order to make the changes consistent with the long-range objectives of our country.

We should not be thinking simply about trying to revitalize the economy for the next 6 months, or for the next 12 months, or, indeed, for the next year or two. We need to think about changes in the Tax Code that will assure economic opportunity and employment and a role for our country economically 5 years, ten years, twenty years down the road, and, indeed, into the next century.

So, it is an important issue and one that I am glad that the Congress has decided to address and to help us as we frame our debate in the coming days.

[The prepared statement of Senator Boren appears in the appendix.]

Senator BOREN. I am pleased to have several of my colleagues here with me; Senator Roth and Senator Danforth. As I say, others will be joining us. And I would turn to them for any comments they would like to make.

Senator Roth.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE

Senator ROTH. Well, thank you, Mr. Chairman, for holding what I consider to be some most important hearings. It is a pleasure to greet our distinguished panel.

I have to say that I have grown increasingly frustrated with statements that claim an intense interest in the issues of competitiveness and the cost of capital, but Congress fails to take any real action.

Instead, Congress has been swift to step up anti-competitive legislation that actually increases the cost of capital and makes it more and more difficult for new businesses to start, young ones to grow, and old ones to mature into worldwide competitors.

Payroll taxes, government regulations, and high capital gains taxes have suppressed small business entrepreneurs. And I cannot begin to explain how frustrating it is to try to pass pro-growth legislation and continually have income distribution tables with questionable assumptions and complete lack of consideration to government spending programs used to stop any and all growth opportunities.

The so-called fairness argument does not take into account spending on low-income people, yet it is used to stop the enactment of pro-growth measures, such as a capital gains tax reduction.

For example, the President's budget includes $100 billion in spending for programs aimed at children, according to Budget Director Darman. But the Joint Committee on Taxation fails to consider any of this money in its distribution tables.

The same is true of welfare, Aid to Families With Dependent Children, and other spending programs that nevertheless is income directly aimed at lower income people.

If I did not know better, I would think that these statistical games are a deliberate effort to throttle the economy so that George Bush would not be re-elected.

Other things should be considered to help the long-term competitiveness of this country. And I cannot help looking at other nations, as our Chairman has, because they seem to be moving ahead of the United States in investment in productive property.

In fact, for example, comparing the period from 1985 to 1989, Japan invested a much larger proportion of its GNP; 29.2 percent, as compared with only 17.2 percent in the United States.

The fact is that in Japan, where the economy is just over one-half that of the United States, they are investing more in absolute dollar amounts than is the United States.

In 1990, Japan's non-residential fixed investment equalled $675 billion, while the comparable U.S. figure was only $524 billion, with a gross domestic product equal to about twice that of Japan.

And worse yet, from 1973 to 1988, savings and investment as a percent of GNP was lower for the United States than for any of our major competitors, with the exception of the United Kingdom.

These are the things that prompted me to introduce a Super-IRA bill with Senator Bentsen, our Chairman, and a new kind of investment tax credit, S. 1831, to encourage savings and investment.

And I am glad to see that the IRA enjoys perhaps the greatest bipartisan support in the Congress of all the major tax proposals, and should help both the country and the family compete in this global economy.

Some kind of investment incentive like an investment tax credit also looks likely. I will continue my efforts to improve my incremental investment tax credit and hope that other Senators will support me.

But we must also look at structural differences in our tax codes between the United States and other nations. For example, the United States remains the only major trading nation that does not have a consumption tax, and I believe we should look at the advantages and disadvantages on U.S. trade of not having such a tax. Perhaps we should move away from taxing production and, instead, tax consumption.

We should also look at how other nations tax capital gains. The United States has the highest capital gains tax of our major competitors, and out of those, Germany and Japan have virtually no tax on capital gains.

Yet, Congress continues to stop this effort to reduce capital gain taxes to conform to our competition, and possibly to be more com-

petitive. But what worries me most of all is the trend that I see in government today.

Too many are arguing that we need to go back to old "tax and spend" ways before we get out of this recession, and those who speak of higher taxes are insensitive to the tremendous harm that they are doing to the economy.

Federal spending is now at a new record high in recent history, equal to more than 25 percent of GNP. But, as President Bush stated in his State of the Union, this government is too big and spends too much.

I believe the American people are overwhelmingly in agreement with that. Having said that, I look forward to our continuing debate on the issue of competitiveness. Thank you, Mr. Chairman.

Senator BOREN. Thank you, Senator Roth.

Senator Danforth.

OPENING STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM MISSOURI

Senator DANFORTH. Mr. Chairman, thank you very much. I can only say it is about time. It is about time we had a hearing like this. You have correctly focused our attention on what we should be focused on.

So often the debate on tax policy when a tax bill looms ahead is a debate on who gets what, particularly in an election year. What are we going to do to give people stuff? But I think that the test of tax policy should not be who gets what, but what builds a stronger country for the future.

I have travelled around my State in the last few months asking my constituents to please tell me if there is anybody out there—anybody—who thinks that our country is going to be made stronger by giving people a $200, $300, or $400 rebate. I have found nobody. Not a single soul who said yes.

I have been on radio programs; the largest radio station in our State, asking people in the radio audience call in program, call me up. Let me know if there is anybody out there who believes that we are going to help the growth of the country by giving people a rebate of a few hundred dollars. Nobody believes in it. Nobody. Nobody believes that it helps build a stronger country.

And I think the American people want the truth. I do not think they want the usual election year stuff. We are going to give you $300 now, may we please have your vote. I think that the answer to that is going to be, no, you are not going to get our vote for that. People want the truth.

The tax system now is, in my judgment, a tax system that compliments our budget deficits. Our budget deficits amount to dissaving, our tax policy rewards consumption, and we say in many of our proposals for changing the Tax Code, let us give people a few hundred more dollars so they can go out, and, as we put it, jump-start the economy.

By that we mean, please go to your nearest store and spend your $200 or $300 on a new Sony. I do not think that is good economic policy.

I agree with Senator Roth. I think that we should give careful consideration to the possibility of a consumption tax.

As he pointed out, we are the only industrial country in the world that does not have one. We have, I believe, the lowest savings and the lowest, lowest investment rate in the industrial world, and the second lowest growth rate over a period of a couple of decades. Clearly, we are doing something that is very, very wrong.

One specific that I would also note that was mentioned by Senator Boren is the effect of the alternative minimum tax on tax policy. If it is true that half of the corporations in the United States are now taxed under the alternative minimum tax, it is something more than it was ever intended to be.

Now, the President's program has a permanent research and development tax credit. That is a very popular program. I think all of us support it. But the President's research and development credit does not apply to corporations under the AMT.

Proposals for an investment tax credit normally do not apply to companies that are taxed under the AMT. And my hope is that either in this hearing or at some future time we can also focus on the perverse effect that the alternative minimum tax is having on economic growth in our country.

Senator BOREN. Thank you very much, Senator Danforth. That certainly will be a focus of these hearings, and I hope that that is something again we can bring to the attention of our colleagues when we consider the tax legislation before us.

Because, as you have said, more important than some small amount of money to be put in people's pockets right now, often to buy consumer products produced in other countries, is the need to restore the productive and competitive capability of this country to ensure jobs and to try to bring an end to the down-sizing and the very painful restructuring that has gone on in some of our industries by giving them a chance to compete on an equal field without the Tax Code interfering with their ability to do that.

Well, our panel today is certainly well-equipped to help us grapple with the issues that are before us and that have already been outlined in opening comments by our colleagues.

All of us on the Finance Committee, and, indeed, in the Congress, have had the privilege of working with the first two panelists who are with us for a long time. We have benefitted from their counsel tremendously and I appreciate their taking the time to be with us today.

Dr. Martin Feldstein is President of the National Bureau of Economic Research. He is the Baker Professor of Economics at Harvard University; previously Economic Advisor to the President of the United States.

Dr. John Shoven is the Schwab Professor of Economics at Stanford and Director of the Stanford Center for Economic Policy Research. Certainly two of the most eminent economics in our country, and we welcome both of you today. We appreciate your taking the time and effort to be with us, and we would welcome your opening comments at this time.

Dr. Feldstein, we will begin with your opening remarks. And perhaps we might hear from both of you and then have questions directed from the members of the committee to both of you at the same time.

STATEMENT OF MARTIN FELDSTEIN, PH.D., PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MA

Dr. FELDSTEIN. Well, thank you very much, Senator. I am delighted to be here, and I was very pleased to hear the comments that all three of you made. I hope that you can find another 50 Senators who share that view and we will be on the right road.

I have a prepared statement that I will submit for the record. What I want to do is just talk for a few minutes to summarize the views in that statement.

Senator BOREN. The statement will be entered into the record.

[The prepared statement of Dr. Feldstein appears in the appendix.]

Dr. FELDSTEIN. I will talk first about the short-term issues and the role that tax policy might play in getting us a stronger recovery, but I really want to focus, as you all did, on the role of tax reform for increasing investment and saving and helping the economy in the long-run.

Now, let me start with the short-run situation. The economy is not in good shape. The current quarter is likely to see a fall in overall economic activity.

The first-half of the year, I think, will be flat. All of this, I think, reflects primarily the overly tight monetary policy that the Federal Reserve gave us in the last half of last year.

I think that the actions that the Federal Reserve took in December are going to work. I think that the lower interest rates will translate in various ways into an economy that is in significant brisk recovery by the summer.

I think it is important, though, for the Federal Reserve to keep its eye on the rate of growth of money and credit over the next several months; that if we once again see the growth of money and credit drop way down as it did last year, then we may again have an economy that is simply not going anywhere.

But if the Federal Reserve does achieve what I think they want to achieve, then a large tax cut to stimulate this economy would simply be inappropriate. It would waste scarce dollars, as I think all three of you indicated.

It would come too late and end up over-stimulating the economy next year when we are already in recovery. And by frightening the financial markets in the short-run, it would run the risk of being counterproductive.

I do think, though, that a modest fiscal package of quick-acting changes could be helpful. We frankly do not know enough about the ability of the Federal Reserve to deliver a more rapid growth of money and credit and there is, therefore, the danger that this economy will continue to slip rather than turning around.

I think speeding up spending on infrastructure is a good thing. That is money that we are going to spend anyway; better to spend it when we have excess capacity.

I think the change in the withholding tables, although they do add, once and for all, permanently to the national debt, does provide a stimulus at an important time. It is not an action that can be repeated again and again, so it will not add to future budget deficits.

It adds, rather, to the immediate budget deficit and the national debt, but I think in a way that can be helpful to stimulate spending. And while spending is not what we need in the long run, it is what we need in the short-run. I think that an investment tax credit or accelerated depreciation retroactive to the start of the year would also be helpful. I will come back to the investment tax credit.

But, in general, I think that more fundamental tax reform should wait until after the election. For the reasons that you all spoke of, trying to do tax policy of a fundamental sort in an election year is likely to do more harm than good.

Now, it is very easy for me to say that. You are going to be under a lot of pressure to have some kind of a middle-income tax cut.

My favorite middle-income tax cut—and it is one that I would do permanently rather than just temporarily—is not some kind of a rebate or personal exemption, but would be to bring back the special tax deduction for second earners that was eliminated in the 1986 tax legislation.

You will recall that was a 10 percent reduction, up to $3,000. What it basically said was that second earners, traditionally married women, would find themselves with a lower marginal tax rate. They are a very sensitive part of the labor force. It would target that tax cut on a group that would have the greatest supply response per dollar.

By limiting that to taxpayers' families with incomes under $75,000, you could focus it just on those in the middle income brackets.

The net cost of doing that would be $6.5 billion a year, less than the cost of virtually all of the proposals that have been made for personal exemption increases for all taxpayers or for children.

Indeed, because of the favorable effect on the labor supply and earnings of second earners, the actual net tax cost would probably only be about half that.

Let me set aside the short-run and talk about the longer run issues that you have raised. I think there are many good things in the 1986 tax legislation, but I think now, with hindsight, we can also see a number of faults. And I hope that in 1993 you will go back to the 1986 legislation, review it, and correct some of those faults.

One very important area is in the incentives for business investment, and plant and equipment. As you recall, in 1986, one of the major themes was leveling the playing field.

In principle, that is a good idea. But I think in practice, leveling the playing field got focused just on tangible business investment: equipment and structures.

And the result was to raise the effective tax rates on business investment in plant and equipment and to discourage spending on that relative to things like advertising or other parts of companies' budgets that are not productive. And it also had the effect of distorting capital into consumer durables and second homes.

I hope that in 1993, if not before, you will go back and reconsider and move toward a permanent investment tax credit or accelerated depreciation as a way of bringing more capital back into plant and equipment and away from other uses.

Let me say a few brief words about capital gains. I favor a reduction in the capital gains tax rates. I think that would reduce the cost of equity capital. It would encourage business investments. Shall I ignore the automatic bell?

Senator BOREN. Please ignore the bell and go ahead.

Dr. FELDSTEIN. It would encourage investments, especially in new businesses and in new ventures within existing businesses; it would encourage R&D; it would encourage new product development; the kinds of things that require patient risk-tolerant capital.

I think the only legitimate justification for not reducing the capital gains tax would be a fear that it would produce a significant revenue loss and, therefore, either add to the budget deficit or require increasing other taxes which would have adverse effects.

My reading of the evidence has convinced me that there would not be a significant revenue reduction from a substantial cut in the capital gains tax and that, indeed, there might be an increase in revenue.

When I look at the estimates prepared by the Treasury and the Joint Committee staff, I see the Joint Committee staff saying roughly that a cut from 30 percent to 20 percent in the capital gains tax would be offset about 80 percent by the additional revenue that comes from unlocking existing capital gains. And the Treasury says, no, not 80 percent, about 100 percent. So, the committee staff says there is a small revenue loss, and the Treasury says there is a small revenue gain.

The truth is that economists cannot be precise enough in our estimates to know which of those numbers is correct. I think they are both in the possible ball park.

My reading of the evidence says that the best conservative conclusion to draw is that a cut of that magnitude would have no real impact on the size of the budget deficit; there would be no real revenue loss.

But I am quick to admit that one cannot be sure whether, in fact, there will be a small revenue gain or a small revenue loss. But treating it as essentially zero seems to me the prudent way of looking at it.

And that, of course, is only looking at the extra revenue that comes from unlocking capital gains. It makes no allowance for increased revenue that comes from increased economic growth, which is, of course, the purpose of this.

And even the smallest increase in the rate of economic growth within a few years would swamp the revenue loss estimated by the Joint Committee.

So, I think bringing the maximum tax rate on capital gains down to 20 percent would almost certainly increase tax revenue when you take into account both the unlocking effects and these growth effects.

It would make the economy better off, since it would not add to the deficit. Nobody would be made worse off in the process. I find it very difficult to see how one can justifiably reject a cut in the capital gains tax under those conditions.

Even a greater cut of the sort that the administration has proposed to 15 percent might well be worthwhile, even if it lost a little bit of revenue because of the very favorable effects on the economy.

Let me turn, finally, to the issue of savings and Individual Retirement Accounts. As you know, our national saving rate is abysmally low. And it is savings that constrain our ability to invest. If we do not raise our savings rate, we cannot raise our investment rate. And if we do not raise our investment rate, our productivity growth is going to continue to be so close to zero that it is hardly noticeable.

Unfortunately, private savings are not only the lowest in the world now, but they fell sharply during the last decade. It really is, I think, a terrible situation that we now face. And we are no longer able to depend upon an inflow of foreign capital to supplement our domestic savings.

The net effect of all of that is that this year, there will be just enough growth of the capital stock to offset depreciation. There will be virtually no, perhaps none at all, net investment in the economy.

I think IRA's are an effective way of increasing savings.

Senator BOREN. Say that again. The statement: there will be no net investment in the economy.

Dr. FELDSTEIN. I think that there could be no net investment. I am not absolutely sure, but I think if you look at the very low level of savings, including the inflow of capital from the rest of the world available this year, it may give us no net investment; just enough investment to offset the depreciation of the existing capital stock.

And it is investment, it is the growth of the capital stock that is the source of real economic growth around the world. Study after study continues to demonstrate that.

So, I worry a great deal about what we can do to get our savings rate up. Now, our savings rate fell in the 1980's for a variety of reasons; some good, some bad.

The increase in the stock market made a lot of people and companies feel that they did not have to do more savings, that their assets had reached higher levels anyway.

Savings fell because of the introduction of home equity loans; because more people had access to credit cards; a variety of reasons. I think that, unfortunately, although the Individual Retirement Accounts were a positive effect, they were not large enough to offset these other adverse effects on savings.

But my reading of the evidence and of the very careful studies that have been done by some economists on that subject indicates to me that IRA's are a net savings incentive for individuals and for the economy as a whole.

Roughly speaking, while there is some diversion of old savings into IRA's, the evidence suggests that every extra dollar that goes into IRA's comes roughly 30 cents out of old savings and the rest out of cutting consumption or reduced tax liabilities. But that means that national savings has to rise even though the government loses some revenue.

When the Joint Committee staff and the Treasury estimate the revenue consequences of IRA's and of increased IRA's, they overstate the cost of those increased IRA's, and, therefore, understate the favorable impact on national saving.

Why? Because they leave out the favorable effect of IRA's on corporate tax receipts. The method used by the staff, both in the

Treasury and in the Joint Committee, only looks at the impact of IRA's on household taxes.

And when I increase my savings, some of that ends up going into investment in businesses. That produces profits. Those profits get taxed. And if you therefore look at the net impact of an IRA on revenue, it is not nearly as unfavorable as the committee staffs suggest.

And, in particular, if you look at so-called back-ended IRA's where there is no deduction up front but only the exclusion of interest and dividends, taking this corporate tax revenue effect into account is very important.

A back-ended IRA has very little revenue loss as conventionally calculated. The revenue loss that occurs does so because some of the interest and dividends that sit in an IRA would otherwise sit in a taxable form. But, nevertheless, there is a calculated revenue loss.

But to the extent that individuals save more and that produces more corporate tax revenue, that more than offsets the loss of personal tax revenue.

Some calculations that I have done but that have not been included directly in the testimony—but that I would be happy to share with you and your staff—indicate that the increased corporate tax receipts more than offset the loss of personal revenue.

And that means that a back-ended IRA would, from year one, be a net revenue producer; would actually shrink the budget deficit.

Well, I think if that is correct—and I believe it is correct—then it is very hard to see why we should not move directly to the adoption of a back-ended IRA.

Unfortunately, as you know, the rules of the budget analysis requires getting that taken into account by the committee staff or the Treasury staff.

I remember back in 1978 testifying before the Senate Finance Committee about capital gains tax reduction. And, at that time, I urged that the committee recognize the effect of capital gains tax reduction on unlocking capital gains.

The staff's view at the time was "we do not do that. We talk only about the static revenue loss, which, of course, would be very large."

Now, fortunately, the members of the committee and of the Ways and Means Committee said that just was not acceptable; that to get a meaningful estimate of the effect of capital gains tax changes you have to take into account those feedback effects.

And I think the same is true about the IRA. You cannot simply draw a line and say, well, we will only count the revenue loss on the personal side, we will not count the revenue gains on the corporate side.

So, I hope that as you consider back-ended IRA's you will be able to get a more appropriate, more correct estimate of the actual revenue effects, including these very straightforward mechanical effects on corporate tax revenue.

Thank you very much.

Senator BOREN. Thank you very much for your testimony. Professor Shoven, we will hear from you now, and then we will direct questions to both of you.

STATEMENT OF PROF. JOHN B. SHOVEN, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CA

Professor SHOVEN. Thank you very much for inviting me. I will follow my written testimony fairly closely. Before I begin, I would like to congratulate the subcommittee for holding hearings on long-run tax policy issues at a time when there is a great deal of concentration on short-run fixes for the recessionary economy this election year.

For the most part, as Marty did, I will refrain from discussing anti-recessionary policies, except where I see opportunities to improve long-run economic performance simultaneously. I am going to concentrate on policies to encourage economic growth and productivity.

The fact that there is something wrong with the long-run performance of the economy is most vividly demonstrated by noting that the purchasing power of the average blue-collar weekly paycheck is no greater today than it was in the late 1950's.

Basically, in these regards—the need for increased productivity—I believe we have three major problems to concentrate on, all of which are related to tax policy. The three problems are inadequate national savings, inadequate national investment, and excessive reliance on debt financing.

I think our net national savings rate is pathetic. It averaged about 2 percent of GNP in the last half of the 1980's and has not improved much since.

All components of national savings declined in the 1980's—personal savings, business savings, and government savings—from their historical range. The national savings rate in the 1950's, 1960's, and 1970's ranged from 7 to 8 percent of GNP, and now it is at 2 percent.

So, what do we do about savings? First, we need to improve the deficit and balance the Federal budget over the next 4 years. My own opinion is that this will require both tight controls on spending and tax increases.

What needs to be done now is to enact strong measures to assure that we are going to eliminate this deficit and to provide confidence to Wall Street and to the average American that this is going to be done.

It strikes me that there is a possibility of doing something that would improve the long-run fiscal position of the economy and stimulate it at the same time. What needs to be done is to enact consumption tax increases that would be effective 18 months hence. Such an action would be fiscally responsible, and it also might stimulate the current economy as people and firms try to beat the tax increase. So, it would be anti-recessionary and fiscally responsible at the same time.

We also need to encourage private savings rather than discourage it. My own goal would be to raise the total national savings rate back to its historical norm of 7.5 percent.

The first thing you need to know about private savings is the staggering role of pensions. It is not too much of an exaggeration to say that pensions are how Americans save over and above the accumulation of home equity and Social Security entitlements.

A staggering fact that I discovered recently is that the Federal Reserve Flow-of-Fund accounts show that the increase in real pension assets in the 1980's exceeded the increase in the real wealth of the country in the 1980's.

So, at least in this sense, all of our savings was occurring in pension vehicles. And this indicates to me that it is counterproductive to curtail the tax benefits enjoyed by pensions or to regulate pensions in order to improve the Federal budget. What such actions do is tax private savings in order to improve public savings. I think that is counterproductive.

The recent Treasury proposal to tax annuity accumulations also struck me as a misguided idea: it was just another tax on private savings in order to improve public savings.

So, what we need, if you think that national savings is our goal, is to tax consumption; not income, not savings.

I personally would favor either a broad-based consumption tax, or one which concentrated on such things as gasoline and energy. Those latter policies would be an effective environmental policy as well as a potentially large revenue source.

I will say only a little bit about Individual Retirement Accounts. I also think that they generate extra national savings. However, I do believe that you should consider removing the ceilings and replacing them with floors. What I have in mind is that all savings would be deductible for low and middle-income Americans. For the wealthier individuals, only savings over and above some floor would be deductible. For instance, the well off might have to save more than 5 percent of their income in order to be able to have the tax advantages of an Individual Retirement Account.

I think you might need to have a very high ceiling of $25,000 a year, or some, and do whatever you want to do in terms of progressivity and incidence by establishing floors.

By the way, in academic circles, a pretty heterogeneous group of people support this. I heard it first from James Tobin, the Nobel laureate at Yale. Recently, Doug Bernheim at Princeton has also been advocating IRA's with floors, not ceilings.

In terms of investment, we certainly have inadequate investment in this country. In the 1980's, the net national investment rate fell just like the savings fell, from an average of 9 percent of GNP to slightly less than 7 percent.

Despite being twice as large an economy as Japan, total investment in Japan has exceeded total investment in the United States for the past couple of years.

Weak investment translates to slow productivity growth which results in the poor performance of wages in the economy. So, it is directly related to the fact that wages have not gone anywhere in a generation.

Investments in corporations are discouraged by the fact that returns on such investments face two levels of taxation: one at the corporate level and one at the person level.

In contrast, the returns on most owner-occupied homes are completely untaxed; the returns on many non-corporate businesses are taxed only at one level. Most economists believe that the double taxation of corporate capital distorts the allocation of capital away from the corporate sector.

I should add at this point that most analyses of the distribution of tax payments across income classes ignore the fact that there are two levels of taxation on capital income and they fail to allocate the burden of the corporate taxation to people.

It is clear that people pay corporation's taxes, either the customers, stockholders, or the workers. It is not like the money is coming from some other planet.

The exception to this remark, by the way, was the late Joseph Pechman, who found that the progressivity of the income tax depended crucially on the incidence of the corporate income tax.

In terms of encouraging private investment—by the way, I think we should encourage additional public investment as well—economists have their usual remedy, which is you should lower the price. The way economists encourage activity of almost anything is to lower the price, and, in this case, the price is the cost of capital.

There are a whole array of measures that could be taken to lower the cost of capital, such as allowing expensing instead of depreciation, re-institute an investment tax credit, index depreciation allowances for inflation, lower the taxation of capital gains, or integrate the personal and corporate income taxes.

The first three of these—accelerating depreciation, restoring the investment tax credit, as indexing the depreciation—work by making more adequate the deductions that firms have for their capital costs. All of them could dramatically reduce the cost of capital. For instance, expensing could lower the cost of capital by a third.

The Bush administration proposal for a 15 percent investment tax allowance, which really involves a simple acceleration of depreciation deductions for equipment bought in a fairly narrow window between now and January 1, 1993 and installed before July 1, 1993, would have a small, temporary effect on lowering the cost of capital. But given that we are talking about long-run policies, that measure is probably not appropriately discussed here.

The investment tax credit does have a problem. It is such a useful tool for stimulating the economy and controlling the level of economic activities that maybe it is not a desirable component of long-run tax policy.

Reducing capital gains taxes operates through a different mechanism in terms of lowering the cost of capital. If you have lower capital gains taxes, it seems only reasonable to think that the stock market would go up.

In fact, it would possibly go up in anticipation of a reduction in the capital gains tax. After the jump in stock prices has occurred, investors can expect lower rates of return on their investments.

That lower rates of return available in the stock market means that firms can rationally and appropriately leave more investments inside their firm, because the investments in the firm need to offer competitive returns with investments available outside the firm.

If managers act in their stockholders' interests, they have to consider all investments within the firm as financial investments. They are spending and investing stockholders' money now, hopefully wisely.

If the stock market has a lower expected rate of return, that lowers the "hurdle rate" that should be used inside the firm. The result is more investment.

My own guess is that a capital gains cut of the dimensions that the Bush administration is proposing would cause the stock market to go up roughly 4 percent—roughly 130 points on the Dow—and that would directly lower the cost of capital by about 4 percent.

That is not as much as you could get with an investment tax credit or with expensing, but still may be worth taking. Particularly if there is only a small revenue cost to this measure.

My own guess is there is a revenue cost, but that its present discounted value is modest. I would favor a lowering of the capital gains tax, particularly if accomplished through indexing for inflation. I would agree with all three of your introductory remarks that we have the highest capital gains tax in the world and we should keep track of how our tax system compares with that of our competitors.

The last problem I will mention—and then I will talk about a bold solution—is the excess reliance on debt. I will not say much about that, except that all this talk about the two levels of taxation of corporate capital applies only to equity capital.

Debt capital is taxed at one level at most. It is not taxed at the corporate level, and often the debt is held by pension funds and other lightly taxed holders.

And so, it is only taxed lightly at one level. This has provided a very strong bias in favor of debt, and I think at a social cost to the economy.

So, I think we do need to try to design in the long-run a tax which is neutral with respect to debt and equity financing, such as a corporate cash flow tax.

The Treasury's recent proposal to tax the return on annuities misguided. It strikes me as somewhat ironic that the same administration that is proposing to lower capital gains taxes and encourage savings and risk-taking is in favor of closing down this vehicle which attracts savings.

But, having criticized them, let me turn around and praise the Treasury Department for its recent and under-appreciated report on the integration of the individual and corporate tax systems. This was just released in the last 3 or 4 weeks.

This report details several alternative long-run proposals to remove the double taxation of corporate capital returns. We are one of the few major economies which does not have some sort of integration between the corporate and personal tax systems.

Some of the Treasury prototype plans are really quite bold and appear to me to be worthy of serious implementation studies.

The prototype proposal that I find most appealing in the Treasury report is something called the Comprehensive Business Income Tax.

The Comprehensive Business Income Tax would work as follows, as the Treasury describes it: it would equate the treatment of debt and equity; it would tax corporations and non-corporate businesses alike, and; it would greatly reduce the difference in the tax treatment of dividends and retained earnings.

Briefly, here is how it would work. There would be no tax on capital income at the level of the equity or debt holder; no tax on dividends, no tax on interest, no capital gains tax. The personal tax system would not tax capital income whatsoever.

However, corporations would pay a tax as they do now, except that business interest payments would no longer be deductible. So, the full return to debt holders and to equity holders would be taxed at the business level, and the rate of the business level tax would be set at the maximum personal tax rate.

So, you have got all business income being taxed at the business level at the maximum personal tax rate, regardless of whether it is debt, equity, corporate, or non-corporate.

And the amazing thing about this proposal, if the Treasury study is right, is that it is revenue neutral. You do not lose any revenue.

Such a system would simplify the tax system dramatically; it appears such a plan would improve saving, investment, and remove the distortions towards debt.

The Treasury suggests a rate of 31 percent for a broad-based Comprehensive Business Income Tax plan and say that that would be revenue neutral.

I think that that has a great deal of appeal. Just to repeat, all business capital, corporate, non-corporate, debt or equity, would face the maximum personal income tax rate, but all taxes on this income would be collected at the business level.

It seems that no one can argue that this is a great tax break for the rich. All capital income taxes would be taxed at the maximum rate, but only once.

It also seems like this proposal offers the possibility of simplicity, which has proven to be a very elusive goal in the Tax Code.

My conclusion is that this subcommittee and the country should be studying the Treasury's long-run integration report with the same intensity that we are considering the administration's other tax package—the so-called growth package—many of whose elements are designed to be effective only over the short-run.

So, this almost hidden Treasury report is actually a very good one, in my opinion, and it needs to be studied with the intent of considering implementation. Thank you very much.

[The prepared statement of Professor Shoven appears in the appendix.]

Senator BOREN. There would be no tax on dividends.

Professor SHOVEN. There would be no tax on dividends, no tax on interest, and no capital gains tax. All capital income taxes would be conducted at the business level.

Senator BOREN. Yes. On the personal level there would be no tax.

Professor SHOVEN. Yes. All tax will be collected at the corporate level at the maximum personal tax rate.

Senator BOREN. Does the revenue pick up because there would be a higher average corporate rate than now?

Professor SHOVEN. No. The revenue pick up comes form the disallowing of the deduction for interest payments at the corporate level and that picks up an enormous amount of money.

There would be a tax at the business level even for tax-free owners of assets. I found it a little startling—and it certainly needs to be studied more carefully—that this prototype was revenue neutral.

Senator BOREN. Yes.

Professor SHOVEN. But it does seem to be a broad-based, simple tax system with one level. Capital income would be taxed at least

as heavily as labor income, because all capital income would be taxed at the maximum personal rate.

Senator BOREN. You would need to phase it in, I presume. Especially for companies that have a very high debt service.

Professor SHOVEN. The Treasury suggests phasing it in over 10 years, rather linearly in the sense that 90 percent of interest would be deductible in the first year, and then it would go to 80 percent, etc. The phaseout of deductibility would be similar to how we phased out the deductibility of consumer interest on the personal tax system. They are proposing the same thing for corporations.

Senator BOREN. Thanks to both of you. I might just address one question to both of you. I gather you would both agree that the 1986 act, while it had the objective of leveling the playing field, has ended up, in its effects, discouraging risk-taking to some degree, and certain kinds of investments.

Both of you are suggesting that a capital gains differential tax rate was one of the ways to address this.

If you could rank them in order of what you think the best ways are to address this imbalance now which discourages risk-taking and investment, what would be your order of ranking of possible steps we might take?

Dr. FELDSTEIN. I agree with your basic summary. The capital gains tax reduction, because it appears to me to be costless, comes at the head of the queue.

But I would not want to interpret that in saying let us not do investment tax credit changes for accelerated depreciation, or some other way, because they really address different kinds of problems.

But I think one could deal with the capital gains tax and then say, now do we want to spend some money to try to encourage more investment in plant and equipment to right the balance between intangible business expenditures, like advertising, and tangible business expenditures like plant and equipment. And I think that should be high on your priorities.

Senator BOREN. I assume also through amendments to the alternative minimum tax as well, in terms of the preference items.

Dr. FELDSTEIN. Yes. I think the alternative minimum tax has not only complicated the tax laws tremendously, but act as a serious barrier to just the kind of things that you would like to see done in the form of investment.

Senator BOREN. Professor Shoven.

Professor SHOVEN. Well, if we are talking about where we want to be in the long run, I have already indicated my feeling that integrating the two tax systems——

Senator BOREN. Right.

Professor SHOVEN [continuing]. Is probably the most important thing. If we are not going to do that immediately or any time soon, I think we do need to make capital cost recovery more adequate. It is hard to choose between accelerated depreciation and an investment tax credit.

In some sense, the issue is whether you want to encourage plant construction as well as machinery and equipment, since the investment tax credit usually only applies to machinery and equipment.

I, myself, would have a slight preference for accelerating depreciation more, but they are generically the same type of proposal.

I favor lower capital gains taxes for somewhat different reasons than many. Right now happens to be a period of low inflation, but I think the full taxation of nominal capital gains can result in extremely high rates.

I know a study that Professor Feldstein did years ago showing in 1 year that all of the capital gains that were realized—and taxes were paid on them—were fictitious. In fact, in real terms, there were no capital gains in aggregate that year.

Just to go back, though, my own preference in the long run would be to integrate the tax on capital income, and that would probably involve no capital gains taxation, no individual retirement accounts——

Senator BOREN. Right.

Professor SHOVEN. No Keough plans. You see, once you do not have any taxation at the personal level of dividends, interest, and capital gains, all investments are treated like IRA accounts.

Senator BOREN. Right. Let me ask, if we did go to a capital gains differential, how large do you think the differential needs to be to be effective?

And also, what do you think the range of holding periods should be to qualify for the capital gains treatments? We have had earlier proposals that were short, in the range of 6 months.

Some of us were concerned whether it would merely encourage speculation instead of investment. You have had other proposals that do not begin the differential until holding periods as long as, say, 3 years.

Do you have any thoughts about what the minimum holding period should be and what kind of differential needs to be in place for it to be a really effective incentive in terms of risk-taking and also an incentive in terms of investment?

Dr. FELDSTEIN. I think every little bit helps in terms of reducing the capital gains rate. I think if you get it down to 20 percent, you are still talking about doing something which is going to be revenue neutral.

If you go beyond that, then you have to start trading off, do you want to spend your revenue on further reductions in the capital gains tax, or do you want to spend it on other forms, other kinds of incentives for investment.

Senator BOREN. Right.

Dr. FELDSTEIN. So, I do not have any magic answer in that range, but I think that it is hard to see why one should not go to 20 percent if, in fact, you can do that without any net cost to the Treasury.

Senator BOREN. Right.

Dr. FELDSTEIN. As far as the holding period goes, I think the process is more complicated than who is an investor and who is a speculator. When new shares are issued, the people who buy them initially may only hold them for a short period of time. They may be venture capital firms.

They may want the liquidity of being able to sell them at the end of the year if they have seasoned enough to look like they are going to have an acceptance in the marketplace. I do not see why they should be penalized from doing that.

The churning that worries a lot of people primarily occurs in tax-exempt institutions, the pension funds, and others. And I agree with John Shoven. We do not want to start raising taxes on pension funds and other kinds of savings institutions.

As long as you do not do that, you are going to have the high turnover investors, no matter what you do about the individual. So, my inclination would be not to impose any kind of significant holding period for capital gains treatment.

Senator BOREN. Professor Shoven.

Professor SHOVEN. I do not have much to add. I think you want to have a short holding period requirement; 6 months or a year. I personally found the administration's proposal acceptable in this dimension, that is, the one, two, and 3-year steps.

Senator BOREN. Right. Let me ask also. One of the problems that we are dealing with, of course, if packages are put together here as we address the short-term, and if capital gains becomes a part of it—which I certainly would hope that it would, because, again, we are addressing some of the long-term problems while also doing something that provides short-term stimulus, which doubles its attractiveness, as far as I am concerned—we have had the political problem that there are those who do not accept the argument that many of us agree with, namely, that it probably is not going to cause a loss of revenues.

Some say that they think it will lose money, at least within a relatively brief period of time; maybe not in the first year. And they agree that those who will benefit most from capital gains tend to be higher income individuals.

Therefore, from the point of view of tax fairness, if there ends up being a loss of net revenue, that the higher income individuals should pay for this loss of revenue as a trade-off.

The President has indicated, I gather, through members of the Cabinet and testimony, that adding a fourth tax bracket could possibly result in a veto of any such proposal.

And I am very worried, because I think the worst thing in the world right now would be for us to have a "political" package to put on the President's desk.

Those on my side are putting together a package they know that will be attractive but that he would be forced to veto. We do not need that kind of politics-as-usual. That would be wrong.

I think it would be morally wrong for the country. I also happen to think it would be bad politics, because what I hear from my constituents is we want you to quit playing these political games. I think it is transparent politics.

So, I think it is bad for the country and bad politics, both. I hope it will not happen. But we are seeking to find a formula that might enable us to move forward on a capital gains proposal that would be acceptable on both sides of the aisle.

Senator Breaux and I have suggested the possibility of a standby fourth bracket that might kick in at, say, $500,000 a year annual income.

We go to 36 percent if you found during a 12-month period a net loss of revenues to the government to the capital gains differential. And that is pretty hard to determine, I understand. As I say, I do not think that that would happen.

But I suppose that this is partly a political as well as an economic question, because we have to find some kind of formula that enables us to move forward to pass a package that would not simply sent down to the President's desk knowing that a veto would be intended.

Do you have any thoughts about this? Is this the right approach? Do you have any alternatives? I know it has some mechanical problems.

Dr. FELDSTEIN. Let me try both parts of that question. Will there be some future year in which there was a revenue loss? Sure. You could have a year in which the stock market does very badly, a lot of people realize capital losses. That would be a funny time to trigger an extra tax.

So, I do not think you can make that approach operational. I think there is no way to tell what the long-run impact is going to be, and trying to do it on a year-by-year basis, I think, would run into this kind of problem.

Senator BOREN. Yes. Or maybe you could have a longer period of time of averaging it, or something else.

Dr. FELDSTEIN. If this is a tax cut package——

Senator BOREN. Right.

Dr. FELDSTEIN [continuing]. That you and your colleagues are going to produce and there is going to be an eye on the question of is it distributionally fair, then I think what you said is very important in terms of the specific language that you use. You said that the gainers should pay for the cost.

Senator BOREN. Yes.

Dr. FELDSTEIN. Now, it is the cost, not the benefit. So, now, if I am right, there is no cost.

Senator BOREN. Yes.

Dr. FELDSTEIN. If the committee staff is right, the cost is only roughly 20 percent of the total benefit. So, the thing to be allocated in those wonderful distribution tables that Senator Roth talked about is not the benefit; it is the cost.

Senator BOREN. Yes.

Dr. FELDSTEIN. Well, if you do that, then I think even though there would be some amount being allocated to the upper income groups since you are doing it as part of an overall tax package in which there are going to be dollars given away to middle-income and lower income groups, I think you would find with that kind of allocation rule—allocating the cost, not the benefit——

Senator BOREN. Yes.

Dr. FELDSTEIN. The high income groups are not going to be disproportionate beneficiaries of a broad package of tax changes.

Senator BOREN. The problem is if you even do it just on a cost basis and you figure that into your bracket structure right now, given the posture of the administration, it might still trigger a veto. So, I am thinking——

Dr. FELDSTEIN. No. I am not suggesting that you raise taxes to offset it. I am saying that you are going to have other tax cuts in other groups. The question is, what is a fair, overall tax cut package?

Senator BOREN. I see.

Dr. FELDSTEIN. And if the criterion of fairness is——

Senator BOREN. Do it that way.

Dr. FELDSTEIN [continuing]. That the proportional reduction for the upper income groups——

Senator BOREN. Right.

Dr. FELDSTEIN [continuing]. Is similar to the proportional deduction for middle and lower income groups, then as long as you are also cutting there——

Senator BOREN. I see.

Dr. FELDSTEIN. And you allocate not the "benefit" but the cost.

Senator BOREN. Balance your package by allocating possible cut-offs. I understand.

Dr. FELDSTEIN. Balance your cuts, but treat the key thing as the "cost," not as the benefit for that purpose.

Senator BOREN. Right.

Professor SHOVEN. I do not have anything to add.

Senator BOREN. I am impinging on my colleagues' time, but let me ask you one last question. I think it is a question they might well want to ask as well.

That is, as you look at the tax structures in other countries, particularly those countries that are competing with us, whether it is those in Western Europe and Japan, or on the Pacific Rim and elsewhere; are there any main elements of their tax codes?

Capital gains, I assume, would be one. Any other major elements of their tax codes where you see that our competitors—producers in competing countries—have a tremendous advantage over producers in this country; areas that we really need to look at closely?

It has always disturbed me. We pass the Tax Code here as if we think we can do it in a vacuum without looking at the rest of the world.

It is absolutely ludicrous that we do not look at tax codes in other countries when we understand we are part of the world economy and that competitiveness is so important to us. Are there any particular areas that you would point to?

Senator ROTH. Could I just add an addendum to that?

Senator BOREN. Yes, sir.

Senator ROTH. Because both Senator Danforth and I mentioned consumption taxes in our opening statement, and some comments were made by one of you in your opening remarks as well.

Because a lot of people feel a lack of a consumption tax—and I am talking about a substitute, not an add-on——

Senator BOREN. Right.

Senator ROTH [continuing]. Handicaps us in our trade picture. I would be interested as to whether you would agree with that; as to whether you think we should undertake some kind of study to determine the impact.

Senator BOREN. Professor Shoven.

Professor SHOVEN. You have already mentioned several of the differences between the U.S. tax system and those of our competitors. We have much higher capital gains taxes. Many competitors have essentially no capital gains taxes.

I mentioned that we do not have an integrated tax system, but we tax corporate capital income twice in the so-called classical manner. The competitive countries now I think universally use consumption taxes more than we do.

A value added tax is almost universal amongst our competitors. There was an interesting study done at the National Bureau comparing the savings of Canada and the United States.

Canada shares many of the same institutions and cultures of the United States, but they have a substantially higher saving rate. And a good deal of that can be attributed to their more generous individual retirement account-type of savings vehicles.

They have savings vehicles for home purchase, for college, and so forth. But they offer a much richer array of those and they also have a much higher savings rate. So, I think we are behind in promoting savings and in promoting growth.

Dr. FELDSTEIN. I think John has certainly emphasized the major categories. We have savings rules which are less favorable; we have capital gains rules which are less favorable; we have an overall corporate tax burden which, because it is not in any sense integrated, is heavier than our foreign competitors.

But I would emphasize what you said about designing tax policy in an international vacuum. That makes less and less sense for our major multi-national corporations who are doing business in different parts of the world; who can locate their productive facilities in different parts of the world, and we keep dreaming up exciting new penalties against doing business in the United States—the interest allocation rules, the R&D allocation rules, the special rules for financial companies and for the financial activities of non-financial corporations—that all penalize American businesses in the international environment.

I think to the extent that the economics profession was a participant in the design of the 1986 tax reforms, I think we did you a disservice by focusing on the domestic economy.

And I think we are not the only ones who did that, but I hope that in what I will call the 1993–1994 environment you will take this broader look at what our competitors are doing and what we are doing, quite apart from what they are doing, that affects our ability to compete.

With respect to the consumption tax issue, in principle, if I could start all over again, I would like to have a consumption tax rather than an income tax.

But does that make me favor a value added tax? No, it does not. Until 1986, until you changed the IRA rules, the substantial majority of American households had a consumption tax.

That is, they could save as much as they wanted, as much as they were likely to save and not paying any tax on it until they took that money out. Very few American families or couples save $4,000, and that was the option they had.

So, we had it, and we had a structure within which by raising those limits, as John said, we could have extended consumption tax principles to more and more of the population. To me that makes much more sense than putting in place a whole new tax structure.

The reason that other industrial countries have value added taxes is not to encourage saving, it is to finance much larger national spending programs.

We spend roughly a third of GNP between the Federal Government and the State and local governments. If you go to Europe, the number is 50 percent or more. So, that is when you want to have

a value added tax, when you decide you want to spend 50 percent of GNP. I hope that does not happen soon.

It may be partly historic. They used to have a so-called cascade or turn-over tax, and this was a transition away from it. The argument that a value added tax with rebates at the border helps exports, I think is just wrong. It might be true in a world of fixed exchange rates, but we do not live in that world anymore, and have not for quite awhile.

Basically, our trade balance is a macroeconomic phenomenon. The difference between our exports and our imports, as you no doubt heard many witnesses say in the past, is the difference between our National saving and investment.

As long as we have a low level of savings, we are going to have a trade deficit, or we are going to have a low level of investment. But it is a macroeconomic question, not a pure trade question. The dollar will fluctuate to bring that about.

Now, what happens if you put in a general value added tax with rebates at the border? Well, the dollar will simply rise to bring us back to the same competitiveness that we had before and there will be no net impact after the dust settles on our competitiveness.

I say a general value added tax because, in fact, nobody really has a general value added tax in mind. What they have in mind is a value added tax that would exclude, say, housing and most services.

If you do that, then the value added tax becomes a tax on manufactured products. It does then, to some extent, discourage imports because our imports are manufactured products.

But, since the trade balance is going to be determined by national savings and investment, if we discourage imports, exports have to be discouraged as well.

So, the net impact, I think, of a value added tax will be to make us less competitive in world markets as exporters. It will help American firms that compete with imports from abroad and will hurt American firms that are trying to export to the rest of the world. I do not see why the Congress should want to do that, and I think that would be the net impact of a value added tax.

Senator BOREN. There may be some difference of opinion here on this.

Professor SHOVEN. Well, no.

Dr. FELDSTEIN. No. He means you agree.

Professor SHOVEN. I agree.

Dr. FELDSTEIN. Good. It is nice to have economists agreeing occasionally.

Senator BOREN. Highly unusual.

Professor SHOVEN. One advantage of achieving a consumption tax via the deductibility of savings through Individual Retirement Accounts or other vehicles, as Marty suggested, rather than through a value added tax, is that you do not get into the constitutional issue between States and the Federal Government about tax bases.

Most of the discussion about value added taxes would be much clearer to the American people if we talked about a national sales tax, because that is what a value-added tax amounts to.

My guess is we can avoid some of these jurisdictional problems by continuing the personal direct tax at the Federal level with savings being deductible rather than getting into the business of having a national sales tax.

Senator BOREN. Senator Roth.

Senator ROTH. I was very much interested and pleased to see that both of you apparently are supportive of an IRA, although you take a different approach.

It is interesting to me, Dr. Feldstein, that you say roughly, I guess, nearly two-thirds results in new savings.

Dr. FELDSTEIN. Well, with a deductible IRA, two-thirds come either from new savings or reduced taxes. So, if I am in the 15 percent tax bracket, then 15 cents comes from lower taxes; 51 cents from new savings.

Senator ROTH. And on the back-ended, as you say, if you include the additional corporate taxes, there is really, basically, no cost.

Dr. FELDSTEIN. That is right. From year one.

Senator ROTH. From year one.

Dr. FELDSTEIN. From the first year. Right.

Senator ROTH. So, if I understand you, a back-ended IRA could be introduced this year with no negative effect on revenue.

Dr. FELDSTEIN. It would help to pay for something else, I think, if you take into account the impact on the corporate tax.

Senator ROTH. No, Senator Bentsen and I have introduced an IRA giving the option of a front-ended or a back-ended with certain flexibility withdrawal for health, higher education, or the first home.

And this IRA has been co-sponsored, I think, in the Senate by roughly 75; in the House by 250, has very broad support, actually. We have Jesse Helms on one side and Ted Kennedy on the other on this piece of legislation.

Now, the administration made certain proposals, what they call the flexible IRA. I wonder how you gentlemen would compare the Bentsen/Roth IRA to the administration's flexible IRA with respect to improving the cost of capital, as well as helping the family plan for retirement and important expenses in the future?

Dr. FELDSTEIN. Will you remind us what the flexible IRA provides?

Senator ROTH. Well, essentially, as I understand it, it takes the exceptions that we provide. In other words, if it permits that first house or education.

Dr. FELDSTEIN. Yes.

Senator ROTH. But it does not expand the IRA beyond the present levels. Now, you professors, I understand, think we ought to do away with the floor and——

Professor SHOVEN. No, the ceiling.

Senator ROTH. I mean the ceiling, and substitute the floor. Yes.

Professor SHOVEN. Right.

Senator ROTH. And you would have no limit——

Professor SHOVEN. I actually think you would want a very high limit.

Senator ROTH. Very high limit.

Professor SHOVEN. Much higher than the $2,000.

Senator ROTH. So, I go back to my question. With the strong support, would the Bentsen/Roth IRA not be a forward step in promoting savings?

Dr. FELDSTEIN. I think it would be. I think you get essentially the same benefit out of just the back-ended half of your plan.

That is, once people understand it, a back-ended IRA in which contributions are not deductible, but then there is no future tax consequence at all; when you take the money out you pay no tax, and as it accumulates you pay no tax. A back-ended IRA offers the same reward for saving as the traditional IRA and without the up front revenue costs.

Senator ROTH. Professor.

Professor SHOVEN. Well, in fact, the back-ended IRA has an additional advantage, which is it gives the contributor insurance against higher tax rates in the future, which you do not have if you invest in a front-loaded IRA. I do wonder whether people have the patience and foresight to see that they are equivalent.

Marty and I both know that in a present value sense that one is as good as the other, but I know that some psychologists or sociologists would probably say that you are going to get more response if you put the goody up front.

Dr. FELDSTEIN. Of course, we have no test of that. The current non-deductible IRA's for people above the threshold are less attractive, because when you take those funds out, the accumulated interest and dividends and so on, accumulated income, is subject to tax.

So, the fact that people are much less enthusiastic about the existing non-deductible IRA's than they were about the old deductible IRA's is quite natural. It shows they know how to make the calculations.

Individuals do not have to wait under a non-deductible IRA to get the benefits that they get under a deductible IRA instead of, for example, of contributing $2,000 to a deductible IRA and saving $500 in taxes but then having to pay tax when the $2,000 comes out with interest later, they could contribute $1,500 now, keep the $500, so they have the same $500 that they would have gotten.

And when the $1,500 accumulates and they are ready to retire, they will get the same amount to spend as they would have gotten by having $2,000 in the IRA accumulating, but subject to tax when they do retire.

So, it has got nothing to do with whether people want their goodies up front, or want their goodies later on. They can have their goodies on the same time schedule once they understand the way the system works. And when people have their own money at stake, they learn pretty quickly about how the system works.

Senator ROTH. I have another question, Mr. Chairman. I take both of your answers as "yes" to my question.

Dr. FELDSTEIN. All right. Fine. [Laughter.]

Senator ROTH. I am very concerned about the impact the so-called distribution charts have. As I mentioned in my opening remark, first of all, I do not think they are valid. I do not think they contain all essential information.

I think it was you, Professor, that mentioned you have got to consider corporate taxes, which I do not think is fully appreciated in our Congressional Budget Office.

But it seems to me that unfortunately too much of our emphasis here is on redistribution rather than growth policies, and that the real problem that we have today, as I see it, is creation of new jobs.

We see, unfortunately, many of our large corporations slimming down with both blue-collar and white-collar workers, none of whom see any chance of being re-employed.

And what we need is an environment of growth and new initiatives and new entrepreneurs. And what worries me about the distribution, getting into this argument of who is benefitting, and, as you say, economics is not a science and there is——

Dr. FELDSTEIN. Well, I would not say that. [Laughter.]

I said it was not as exact as it sometimes——

Senator ROTH. Well, as a C student, I would say it is not exact. [Laughter.]

Well, anyway, do you agree that the so-called distribution and the problem with the budget summit is that if you lower tax one place you are supposed to raise it somewhere else? That can eliminate any beneficial impact.

Are we not setting up some artificial obstacles that are not going to get at the real problem of growth, and growth depends on savings and investment in equipment?

Professor SHOVEN. I think I am in general agreement with you. I think it is extremely difficult to calculate appropriately these distribution charts.

For instance, I have already mentioned that corporate tax is not allocated. But take another example: high-income people often buy municipal bonds. These municipal bonds are so-called tax-free.

On the other hand, they accept yields on these bonds of, say, 6 percent rather than getting a yield of 8 or 9 percent on a taxable bond.

They, in fact, are sacrificing that yield to the benefit of typically the local or State government that is doing the borrowing. To say that they are not paying taxes is not very insightful.

So, there is another example of where you really wanted to calculate the contributions to the financing of governments. You cannot do it quite as simply as people do.

I am as concerned by the jobs and wages issue as you are. In the 1980's, the hundred largest firms in the United States did not generate any net new jobs, which strikes me as pretty remarkable. And I have already focused on the fact that blue-collar wages have not gone up in a generation.

If our saving behavior does not change, wages may not go up for another generation. We literally could have 50 or 60 years at the same wage rate, which does not strike me as the same United States that I envisioned as I was growing up.

Dr. FELDSTEIN. Let me just comment on that last fact which John had mentioned earlier. It makes things sound gloomier than they really are.

The way in which one generation does better than the previous generation in America is they change the kind of jobs they do.

So, when you look at blue-collar workers, you are looking at a smaller, and smaller, and smaller fraction of the overall labor force.

The children of last generation's blue-collar workers are today's secretaries, businessmen, airplane pilots; they are doing a different kind of job and they are being paid more.

So, you are really comparing apples and oranges when you compare the much larger group of people who had blue-collar jobs in the past with those today.

On this point about the distribution tables, I think they created terrible mischief in 1986 by ignoring the corporate tax and distributing only the changes in personal taxes. The substantial $25 billion corporate tax increase was not allocated to anybody. A reasonable allocation would have allocated that primarily to higher-income capital owners.

And so, when they looked at those tables, as you know, they said, well, given the rate cuts that have been put in place, we have a substantial problem of balancing. And that ended up, I think, costing us the higher tax on capital gains.

Professor SHOVEN. In 1986 people should have been suspicious when they heard that we had a revenue-neutral tax where I think it was over 80 percent of the people were going to pay less tax. They should have recognized that something was missing.

Dr. FELDSTEIN. Indeed, every broad income class was going to pay less tax.

Professor SHOVEN. Right.

Senator BOREN. Thank you, gentleman. Thank you.

Senator Danforth.

Senator DANFORTH. I only have one question to ask. You, I am sure, followed the various descriptions of income tax cuts. Do you believe that these proposals are sound?

Dr. FELDSTEIN. These are things like the changes in personal exemptions and so on?

Senator DANFORTH. Yes. The President has one, which is a $500 increase in the personal exemption for children. That is his version of it.

I think various members of Congress and some of the Presidential candidates have ideas for middle-income tax cuts: increasing the personal exemption, or it can be reducing rates, or so on.

But the idea is to "jump-start the economy by providing a middle-income tax cut."

Dr. FELDSTEIN. And these are, as I remember, permanent changes. We are going to jump-start the economy forever, so-to-speak. No, they clearly are not the way to increase productivity and growth in the economy.

And, as I said in my prepared remarks, if something is to be done that specifically focuses on the non-investing, not very much saving part of the population, what I would do would be, in effect, to cut the marginal tax rate on second earners by bringing back the 10-percent deduction on second earners' wages.

Senator DANFORTH. If something is going to be done. But do you think that is something——

Dr. FELDSTEIN. That is not high on my list of things that ought to be done. I would focus, as these hearings have.

Senator DANFORTH. That is a very grudging statement, as I understand it. Right?

Dr. FELDSTEIN. That is correct.

Senator DANFORTH. But I want to return to the question. Because this is what we are going to be voting on.

Dr. FELDSTEIN. Right.

Senator DANFORTH. Unfortunately, we are not going to be voting on the things you have described. I wish we were. But what we are going to be voting on is how to dish it out in an election year.

And what I want to ask you is, we are going to be told with great piousness, well, we have got a recession, and we have to jump-start the economy and the way we are going to do it is to provide $200, or $300, or $400, or $500 for children only, or whatever it is. And what I want to know is are those proposals good for the economy, or are they bad for the economy?

Dr. FELDSTEIN. I think, on balance, they are bad for the economy.

Senator DANFORTH. Why?

Dr. FELDSTEIN. There may be cases to be made for it in terms of fairness; distribution of the tax burden between, not income classes, but between families with children, single taxpayers, and so on. But that is a separate issue from the question, what does this do for growth.

Senator DANFORTH. So, if the question is what is good for the economy, we are in a recession and people say the country is headed in the wrong direction, not the right direction.

And we are talking about the future and whether people are going to have jobs, and so on in the future. What is good for the economy? Are these proposals good or are they bad?

Dr. FELDSTEIN. No. These are counterproductive proposals for the long-term health of the economy and since they are permanent changes rather than temporary changes, they are really not targeted at providing an extra little spark in the short-run.

Senator DANFORTH. They are election year give-aways, are they not? They increase the deficit.

Dr. FELDSTEIN. Well, they do do that.

Senator DANFORTH. And they do not have any real effect, do they, on savings, or investment, or plant and equipment, or the kinds of things that make for a stronger country?

Dr. FELDSTEIN. I agree with that, too.

Professor SHOVEN. It does seem like if you are going to lower taxes, you should try to solve some of the problems that we have been talking about at the same time: growth, the reliance on debt, or what have you.

But secondly, these measures, in some sense, count on the American people being rather stupid in the sense that the American people know that we have a $400 billion deficit, and they know that if taxes are lowered now, they are really not going to be better off.

They are just going to end up with higher taxes later. There was a famous Framm oil filter advertisement that said, "You can pay me now or you can pay me later. I do not care." That same logic is true about the Federal Government.

So, thinking that people are going to be better off and get the economy rolling with such measures strikes me as misguided.

Senator DANFORTH. Would it be better to have no tax bill than to have a silly tax bill?

Dr. FELDSTEIN. Yes.

Professor SHOVEN. Yes.

Dr. FELDSTEIN. But if you are going to have to have a tax bill, despite the wisdom of the members of this subcommittee, and it is going to have to have a component that large numbers of middle-income Americans will identify as helping them, then I come back to commending to you the reduction in the tax rates for second earners as something that does little harm.

Senator DANFORTH. Marty, you have three times paraded that dog before us—[Laughter.]

And it almost seems as though you are really thrusting it forward. But you are not, are you? I mean, you are saying, if we must, that is the best way to do something that we should not do anyhow.

Dr. FELDSTEIN. Exactly.

Senator DANFORTH. All right. Now, let me just ask you one other thing. The tax credit for the first-time homeowners, is that a dud, too?

Professor SHOVEN. Well, that is a funny one in the sense that it does seem to me that it might stimulate the economy, construction, jobs, and so forth. So, it does look advantageous over the short run.

But in the long-run, it is exactly the wrong way to go. If anything, we are over-invested in housing in this country relative to other assets. So, I am pretty conflicted as to whether this is a good idea or not. It is definitely something we would want to reverse.

Dr. FELDSTEIN. Well, it is only proposed as a 1-year plan, so that is a very big difference from these permanent costs. But it is a way of diverting spending away from plant and equipment and then into housing.

Senator DANFORTH. These things cost money, do they not? I mean, the middle-income tax cut, the tax credit for this or that. I mean, these cost money. Do you think that the proposals outlined today are worth doing? I mean, there are aspects that are, I am sure. But, I mean, would you recommend that we forget about them and go home?

Dr. FELDSTEIN. Well, it depends on what is at risk. I mean, I think the administration's proposed accelerated depreciation is a good thing. I would like to see it made permanent later on and increased.

Senator DANFORTH. You would rather have a permanent investment tax credit than——

Dr. FELDSTEIN. Or a permanent acceleration of depreciation.

Senator DANFORTH. Sure. Either way than that 1-year deal.

Dr. FELDSTEIN. Right. But a first-year would be a plus in terms of stimulating the economy. I do worry, as I said in my prepared remarks, that despite the Feds interest rate cut in December, that may not turn out to be enough, and a little bit of help of the right sort would be a good thing.

I think lowering the capital gains tax now would be a helpful thing to the economy in the short-run, not because there would be a surge of new businesses, but because the owners of stocks and other kinds of assets would respond positively in terms of their

spending behavior to this in the short run; while in the long run, it would have these favorable effects on the supply of investment and risk-taking. So, I think there are some things that would be better done before you left town. But if the cost of doing them is to do a lot of other bad things, then maybe you should just pack up and go home.

Senator DANFORTH. And you know that it will be, do you not?

Dr. FELDSTEIN. I will not tell you what I think is an alternative if you have to do something, because you have already heard it three times. [Laughter.]

Senator DANFORTH. I am sorry for calling your thing a dog. I will call it your thing. Professor Shoven, do you have anything to add?

Professor SHOVEN. I do not disagree with what Marty said.

Senator DANFORTH. There are some good aspects to the proposals——

Professor SHOVEN. Absolutely.

Senator DANFORTH. But if you net it all out, how would you rank them?

Professor SHOVEN. Well, again, I am most favorable towards the pro-investment aspects. The investment tax allowance, again, I would like to see that stay on, but I do think it will stimulate the economy and it is actually consistent. It is good short-run policy; it is good long-run policy. Capital gains, probably the same. But it is these——

Senator DANFORTH. Permanent R&D credit.

Professor SHOVEN. Permanent R&D credit seems like a good thing.

Senator DANFORTH. Yes.

Professor SHOVEN. The housing one, on net, I probably oppose it because of the fact that I really think it is corporate capital that we need and not housing capital in the country. And if we need more stimulus, we should stimulate corporate capital further.

The $500 increase in personal exemptions strikes me as making the least economic sense of any of the proposals.

Senator DANFORTH. Thank you.

Senator BOREN. Thank you very much. Senator Danforth and I want to say to the witnesses again that in spite of the browbeating here that Senator Danforth has given some of our witnesses, we do want you to know that we appreciate you being here.

I mention one other issue. If we talk about middle-income relief, see if you think this makes sense. The interest deduction on education loans that many middle-income families are forced, not by choice, to take out to send their children to college.

The middle-income are the main group impacted by that proposal. I assume that would be something that you would not have too much objection to, because at least it also is encouraging investment in human capital. It is targeted middle-income relief, as opposed to the sort of broad-based $500 tax credit proposals.

Dr. FELDSTEIN. Yes, although I would much rather see stronger incentives for people to accumulate for that——

Senator BOREN. Well, I agree.

Dr. FELDSTEIN [continuing]. Rather than to draw off savings for other things. Though I would love to see it paired with something that provided strong incentives for educational saving——

Senator BOREN. Yes. I agree.

Dr. FELDSTEIN. And maybe phased on down as people were assumed to do the accumulating.

Senator BOREN. Some of us are working on that. In fact, we have a three-part plan that some of us have introduced which includes a savings plan, it includes the IRA withdrawal penalty suspension, but it also takes care of the immediate stress that a lot of families, unfortunately, just are not in a position to meet now.

Dr. FELDSTEIN. Yes.

Senator BOREN. We appreciate your being here very much, and the time you have given us. We are glad to hear that some of those involved with the 1986 Act are now feeling we should pay a little more attention to the international impacts of some of the things we did.

Being from the part of the country I am from, we always believe there is a chance for redemption on certain points, and we are very glad to have you here.

Dr. FELDSTEIN. Thank you very much.

Senator BOREN. It has been very helpful to us, and excellent testimony that I know all our colleagues on the full committee will be reading. Thank you very, very much for coming.

Dr. FELDSTEIN. Thanks very much.

Professor SHOVEN. Thank you.

Senator BOREN. I now ask our panel to come up from the business community. Our panel includes CEO's who are dealing with companies that are very much involved in international competition. They can speak to us first-hand in terms of the impact of the Tax Code on their ability to produce and to compete.

Our panel includes Mr. Charles Corry, chairman of the board and CEO of USX Corp. of course, a major producer of energy and metal products. The company's operations are conducted through Marathon Group in Houston, and the U.S. Steel Group, of course, in Pittsburgh; George Hatsopoulos, chairman of the board and president of Thermo Electron Corp. in Waltham, MA. His company also has plants in the United States, Germany, and Japan.

He is the author of several articles concerning the cost of capital for U.S. business, and, I might say on a personal note, is one of the first people to begin the process of educating this Senator about the dangers that we face due to an unfavorable comparative cost of capital in this country with other nations, and I am grateful to him for sparking my interest on this issue early on.

Winston Chen, chairman and co-chief executive officer of Selectron Corp. in San Jose, CA. His company provides manufacturing services to major computer and electronics companies. He accompanied the President on his recent trip to Japan.

And, finally, Edward R. McCracken, president and CEO of the Silicon Graphics, Inc. of California. Silicon Graphics designs, manufactures, markets, and services visual computer systems which are used for conceptual design analysis and simulation.

I have had an opportunity to look a little bit at what they do. It is sort of a divine mystery to me, but a very fascinating product and a very interesting business enterprise.

The Sanford Graduate School of Business awarded his company the 1991 Entrepreneurial Company of the Year award.

We are very happy to have all of you with us. I think probably what we will do—and I apologize, but given the lateness of the hour—we will receive your full statements for the record, if you could summarize and highlight for us. I think it would be best for us to have each of the panel give his opening remarks and then we will turn to quest'ons that members may have.

So, we will begin, Mr. Corry, with you. We appreciate you taking the time to be with us.

Well, we do have a vote. Well, Senator Danforth, do you want to go vote right now, and then when you come back, I will go vote.

I will whisper to Senator Danforth what you said when he gets back from voting and that way we will not have to recess the hearing unless we get down to the time limit here. We may have to recess for a minute or two, but we will try to keep going as we take turns voting.

Thank you very much for taking time to be with us today.

STATEMENT OF CHARLES A. CORRY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, USX CORP., PITTSBURGH, PA

Mr. CORRY. Thank you, Senator. I am Charles A. Corry, and I am chairman and chief executive officer of the USX Corp. We are engaged, as you indicated, in energy, through the Marathon Oil Company, and in steel through the United States Steel Corp.

Both of our companies are capital-intensive and face strong foreign and domestic competition. And there is no question that U.S. tax policies have a material impact on our ability to compete in the international marketplace, and I appreciate the opportunity to provide my views on this important subject to the committee.

Before turning to what I think the appropriate future course of tax policy should be, let me first focus on why the current system is not well conceived.

We are concerned about the direction that tax policy has taken in this country since 1982. Tax legislation since that time has been revenue driven, with little consideration given to the effects on international competitiveness, even though our markets and competitors are global.

As a result, our current tax law is anti-competitive and gives our foreign competitors a distinct advantage.

One of the most anti-competitive aspects of current tax law is the Alternative Minimum Tax, or AMT, which went into effect in 1987. The AMT was designed to ensure that corporations with substantial economic income would not be able to avoid Federal income tax payments.

With the perception of fairness as an overriding objective, Congress did not sufficiently focus on the perverse impact the AMT would have on capital-intensive companies, and especially those which operate in cyclical industries, such as energy, steel, motor vehicles, chemicals, airlines, and others, where profitability is often marginal.

Our 1991 results provide a good example of the impact of the AMT on corporations such as ourselves. In 1991 on a reported earnings basis, we lost $578 million and had a corresponding substantial net operating loss for regular income tax purposes.

Despite these losses, USX paid Alternative Minimum Taxes for 1991. And the primary reason for this result is that under the AMT framework, capital cost recovery is much slower than under the regular tax.

USX's capital spendings amounted to nearly $6.6 billion since 1987 when the AMT went into operation. Investment of this magnitude has and will continue to be necessary for us in the businesses we are in, but the AMT depreciation treatment really punishes these productive investments.

Prior to 1987, the cash flow effect of Federal income taxes tended to be counter-cyclical. Taxes reduced corporate cash flow as taxable income increased and had a positive impact in lost years due to the ability to carry losses back to prior years and receive a current refund. This relationship changed drastically as a result of the AMT.

What we now face is a tax system which is pro-cyclical in that it amplifies the negative cash flow effect of a recession on companies which leads to a slower economic recovery.

Mr. Chairman, you have already recognized the problems associated with the AMT system, as evidenced by your introduction of S. 2159, which includes provisions to provide significant improvement in the use of AMT credits and to exclude the depreciation preference from environmental expenditures.

While we would prefer a more fundamental solution to the AMT capital recovery provisions, this kind of thinking is very helpful and what we need to make U.S. companies more competitive.

President Bush has also recognized the negative impact that current capital recovery and AMT provisions have on industries like ours. However, enactment of President Bush's specific proposals would have only a very minor impact, as his plan does not provide a long-term, meaningful reduction in the cost of capital.

If our Nation is to continue to rely on the current income tax-based system, we need a much more dramatic improvement in the capital recovery provisions under the AMT.

Now, to turn a bit visionary, I am convinced that our present tax system must change if U.S. industry is to be world competitive. Virtually all of our major trading partners already have a border adjusted tax that is levied on imports and rebated on exports.

Under the current tax system, American companies' sales are taxed twice. They are subject to the U.S. income taxes on products manufactured here, and a value added tax is imposed by most of the countries where American products are shipped.

However, when foreign companies export their products to the United States, these sales are exempt from their home country value added taxes and there is no comparable U.S. tax imposed on these imports as they enter our borders.

The adoption of a properly constructed border adjustable tax would help put domestic industries on a more equal tax footing with most of our foreign competitors.

Such a tax would have a further positive impact, as it would apply to foreign companies which now largely escape U.S. taxes altogether.

We support the concept of replacing the entire present income-based business tax system with a broad-based consumption type tax.

Mr. Chairman, that completes my prepared statement.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Corry appears in the appendix.]

Senator BOREN. I hope all of my colleagues will pay attention to the description you gave of the alternative minimum tax. You had losses, but were still thrown into this Alternative Minimum Tax because of your level of capital investment.

I think that the average member, even of this committee, let alone in the Senate and the House, believes that the only purpose of the minimum tax was to tax people that had huge profits and that were avoiding paying any tax whatsoever.

I do not think they begin to understand the way the so-called Alternative Minimum Tax actually works and how it penalizes the very things that we were supposedly giving incentives to do in the Tax Code. And I think your example is a very dramatic one, and I hope people pay attention to it.

We will pursue this later, but in terms of your idea of adjustable border taxes; I would be interested to hear how GATT might affect that and whether there is a way to structure it, let us suppose, if we did not go to a consumption tax, which, of course, would require a lot of debate in the country.

I think there is some merit to it. But if it did not happen overnight, is there a way within our current Tax Code that we could do this in a way that would be in keeping with the GATT rules. We might come back to that.

Senator Danforth should be back in just a minute. Mr. Hatsopoulos, I am a little bit afraid to start because I am down to about 3 or 4 minutes, I think, on the vote. I think what we had better do is take a very brief recess. If you would just sort of stay in the area.

As soon as Senator Danforth gets back, I will have him resume, and I will be back in about 5 or 6 minutes. But I had better run over to the floor and vote. So, we will take just a very brief recess and then we will be right back. Thank you.

[Whereupon, the hearing was recessed at 4:05 p.m.]

AFTER RECESS

Senator DANFORTH. Shall we reconvene? Are you up next, Mr. Hatsopoulos?

Mr. HATSOPOULOS. Yes.

Senator DANFORTH. I think you are.

Mr. HATSOPOULOS. Yes.

Senator DANFORTH. Thank you.

STATEMENT OF GEORGE N. HATSOPOULOS, Sc.D., CHAIRMAN OF THE BOARD AND PRESIDENT, THERMO ELECTRON CORP., WALTHAM, MA

Mr. HATSOPOULOS. Well, Senator Danforth, I am delighted to be here. We have talked a lot more in the past about the cost of capital, you, and I, and Senator Boren.

My presentation is going to be a little more related to the analytical work I have done relating to competitiveness and the cost of capital.

As you very well know, we still are on a down slope as far as competitiveness. We are still seeing the Japanese and Germans gaining market share in many segments of business in which we were predominant. Even in high-tech, where maybe 8 years ago we had extremely high market share, we have been losing it regularly.

And they have been—the Japanese in particular, but also the Germans—very aggressive in developing new businesses and penetrating new markets.

Now, such an aggressive pursuit of market penetration by our competitors, of course, has involved very heavy investments. The previous panel has focused primarily on tangible investments.

I would like to point out that as time goes on, the competition internationally will be very heavy on intangible investments; investments such as R&D, or market development. And the balance is shifting although tangible investments are still playing a major role.

The fact is that these very high rates of investment for both tangible and intangible assets by the Japanese and the Germans imply that their actual corporate returns must be lower than ours.

And, in fact, if you look at the national accounts, the corporate returns in Japan are lower than in the United States. The average return in non-financial corporations over the most recent 5 years was 11.1 percent, adjusting for inflation, but, in Japan, it was only 6.2 percent. The same thing was true in the past.

The reason I am bringing this up is because the question is what allows Japanese corporations to have much lower returns? They have much lower returns and yet, they get tremendous new equity financing, whereas in this country we are getting high returns and we are getting negative equity financing.

The answer to that question is that the costs of capital today, even though it has changed, are between 80 and 120 percent higher in the United States than they are in Japan.

Now, the cause of those lower capital costs right now are different than they were when I first met you in 1983. At that time, Japan had lower interest rates and they had higher corporate financial leverage.

What has changed since then is the leverage in Japan has decreased. Their interest rates have come closer to equilibrium with ours. But there was a dramatic divergence in the cost of equity between Japan and the United States.

The reason I brought back the intangibles that also were discussed by Professor Feldstein, is that the cost of equity is particularly important for intangibles; for new technology. And this is going to hurt this country quite a bit.

Now, the primary reason why the cost of equity is so much lower in Japan, and the same is true in Germany the numbers have been identified in the past—is the low savings rate in America.

The second cause is the double taxation of retained earnings, and John Shoven talked about that. It is a very major reason. And, of course, another issue, the AMT is another important issue that causes the cost of capital in this country to be much higher.

So, let me come to the conclusions of what are the most important tax policy recommendations. First, we have to reduce and

eventually eliminate the bias of the Tax Code that favors consumption over investment.

Secondly, we have to reduce and eventually eliminate the double taxation of retained earnings, which favors debt over equity. So, our problems are the favoring of debt over equity and the favoring of consumption over investment.

In order to change that we have to shift the Tax Code away from taxing incomes, and more toward taxing consumption. Either through integration or capital gains tax targeted on equities, we have to eliminate the double taxation of retained earnings, as has been done in Germany and Japan. Otherwise, we will continue losing the competitive war.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Mr. Hatsopoulos appears in the appendix.]

Senator DANFORTH. Dr. Chen.

STATEMENT OF WINSTON H. CHEN, Ph.D., CHAIRMAN AND CO-CHIEF EXECUTIVE OFFICER, SOLECTRON CORP., SAN JOSE, CA

Dr. CHEN. Senator Danforth, my name is Winston Chen, chairman and co-CEO of Solectron Corp., headquartered in San Jose, CA.

We are the nation's second-largest public manufacturing service company in the electronics industry. Solectron employs 3,300 people, of which 3,000 are located in the Silicon Valley.

This afternoon I would like to give you an actual example of how small and medium-sized companies create jobs, and also how venture capital investment helps small and medium-sized companies create jobs.

Personally, in the last 5 years or so, I have two major concerns for American workers. Number one, earlier Senator Roth mentioned about big companies losing jobs.

In the last 10 years, Fortune 500's have lost 3.5 million jobs. It is the small and medium-sized companies creating jobs; they have created approximately 17 million jobs. And they create economic vitality. But they need help, both financially and management-wise.

The second concern I have is institutional venture capital investments. New emerging growth companies have fallen from $4.3 billion in 1987 to estimated $1 billion in 1991, due to a 1986 Tax Reform Act. And this, certainly, will hurt small and medium-sized start-up companies.

I would like to have a brief description of what we do. We provide manufacturing services to major computer and electronics companies such as IBM, Microsystem, Apple Computer, Hewlitt-Packard, Silicon Graphics, and many other emerging growth companies.

And the products we build include surface mounted technology printed circuit boards, flex cables, computers, and software packaging. And these products are used in the field of computer communication, avionics, and medical electronics, and they are being used to improve productivity or creating new market applications.

We have been in business for 14 years, and I have been with Solectron for 13½ years. When I joined the company in 1978, we had 15 people; a very small company.

First, my partner and myself raised seed money of $300,000 from private individuals and we used this money to grow the company to sales of $50 million in 1984.

To continue the growth, we had to raise $8.2 million in a private placement from venture capital firms and financial institutions.

We used this money we have raised in 1984 to invest in new technology and printed circuit board surfaced mounted technology, and this investment helped our company grow to $265 million in sales in fiscal year 1991, ending August 31st.

In the last 14 years, our compounded growth rate was 59 percent per year, and we have become one of the top leaders in the surface mount technology and have established the largest surface mount technology facility on the west coast.

We took our company public in November 1989 and have created significant stockholder value for our investors. And many of our managers and employees are stockholders of the company and enjoy the growth opportunity.

Now, as a result of the venture capital investment and our people's dedication and entrepreneurship, we have created 3,000 jobs in the manufacturing sector in the United States. People thought, we cannot maintain manufacturing jobs in the United States. We proved differently.

We have paid more than $16 million in Federal and State taxes in the last 3 years. Now, if we move our factory to Singapore or Malaysia, we could hcve a tax holiday for 5 years. That is our competition.

And if you do not know, you look at a small disc drive industry, maybe close to 100,000 jobs that transfer to Asian countries. And that is the international competition.

Our employees have paid probably over $90 million in Federal and State income tax accumulatively in the last 14 years. In addition, we generate about $150 million of annual business for our suppliers, and who pay taxes.

So, I must emphasize that without a venture capital investment, we could not have created these jobs and taxes.

Now, our businesses really focus on the belief that American manufacturing companies must revitalize our manufacturing competitiveness. And really, it is through this kind of investment in technology, and process, and quality that we can compete, and we become one of the major leaders in this new technology. And, as a result of the improvement, we won the Malcom Baldridge National Quality Award.

Now, in summary, I believe that long-term, venture capital investment is critical for the formation and growth of small and medium-sized companies, particularly in the high tech areas.

By reducing the capital gain tax, increasing R&D tax credits, making it a permanent credit, and reinstating investment tax credit, I think we can stimulate our economy and create new jobs.

Now, personally, this is my opinion on the following things. American companies are facing tougher and tougher international competition. Many foreign companies with which we compete are

supported by their governments with some very strong industrial policy.

We do not necessarily need industrial policy, but foreign countries do, and that creates a favorable investment environment and other government assistance. I think the future growth of our economy not only depends on the competitive strength of the business in this country, but also we need an environment that has competitive advantages of the nation. In the future, it will be a nation competing with nations economically.

In my opinion, American government is inadequate in providing an environment that has enough competitive advantages for American companies to compete in the global market.

The net results seen are tax policy, educational system, Federal deficits, trade policy, lack of quality leadership, and technology strategy.

Unless we do something differently, I think we are running a risk for America to turn into a second-rate economic competitor in the world. And I believe reducing the capital gains tax is the right step in the right direction. Thank you very much.

Senator BOREN. Thank you very much, Dr. Chen.

Now we will turn to Mr. McCracken.

STATEMENT OF EDWARD R. McCRACKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SILICON GRAPHICS, INC., MOUNTAIN VIEW, CA

Mr. MCCRACKEN. Thank you, Mr. Chairman. I am Edward McCracken, president and chief executive officer of Silicon Graphics.

I would like to talk to you about competitiveness, but, before I do that, I would like to give you a little feeling for Silicon Graphics so that you have an understanding of my perspective.

We are a little too new to be well-known. Our company was founded in 1982. We design, manufacture, and sell very high-performance computer systems and our particular expertise is in the area of state-of-the-art high performance color computer graphics.

I am not here because our company is in trouble. In fact, in 1984, our revenues were $5 million, and now, just 7 years later, our revenue run rate is $700 million.

Our systems are used by NASA; the commercial aerospace industry; the defense industry; they are used by the automotive companies; they are used by environmental scientists to better understand the planet; they are used by architects to build buildings; and they are used by biochemists to build new drugs.

And, perhaps most interestingly, by the broadcasting and movie industries to do special effects in new movies, like "The Beauty and the Beast" and "Terminator 2."

Actually, the creation of Silicon Graphics was facilitated by a government program. Our founder's original work, done at a major university, was done with a DARPA grant.

With this technology and a business plan, we were able to attract over $30 million of venture capital between 1982 and 1985, back when capital gains enjoyed the benefits of a lower differential tax rate.

We are not laying people off. We have directly provided jobs in the United States for 2,200 people in 33 States, and an additional 550 jobs in 25 other countries.

At the present time, we are adding people at the rate of 150 to 300 people per quarter. In addition, we create more jobs indirectly at our suppliers, subcontractors, software partners, and customers. Over a period of 10 years, we have created an enterprise with a market value today of $1.25 billion.

So, who wins? Well, the investors win, the country wins. But also, at Silicon Graphics, every single employee is granted a stock option, because we believe that sharing in the ownership of the company is critical to our ultimate success. Stock options allow a company likes ours to attract and retain the very best.

In terms of international competition, our revenues are divided approximately half and half between the United States and the international market. We have a positive balance of trade with both Japan and Europe, and, in fact, in calendar year 1991, we sold over $90 million worth of product in Japan.

Now I would like to address the three areas in which I believe a change in long-term tax policy of the country could have strikingly positive benefits.

Number one, stimulate research. The heartbeat of any leading edge technology company is research and development. Aggressive spending allows us to stay competitive.

The tax savings directly attributable to the research and experimentation tax credit has been used to finance additional research and development projects.

I believe that the annual pattern of changing and extending the credit substantially decreases the credits incentive effect. A permanent extension of the R&D credit is vital to America's competitive position.

I cannot emphasize enough the role that research and develop plays in the competitiveness of the U.S. economy. New products mean new jobs and, thus, renewed growth.

Number two, stimulate the use of this technology. In order for U.S. corporations to either become competitive or to continue their competitive advantage, it is critical that U.S. workers have access to state-of-the-art development and manufacturing technology.

Accordingly, I urge you to reinstate a permanent investment incentive for purchases of new capital equipment. We need to support the upgrading of our National technology infrastructure through permanent capital investment incentives.

Number three, and perhaps most important, capital gains. The 1986 Tax Reform Act has had a negative impact on young, emerging, high-risk, high-growth companies. It has penalized long-term investors by increasing the long-term capital gains rate.

This approach has signaled to corporations and individuals alike that long-term investment is at least unnecessary, if not foolhardy. The short-term investment focus created by this environment puts young, high-growth companies at a disadvantage as they struggle to raise new capital.

Simply put, there is no longer enough patient, high-risk capital to keep new companies and new jobs flowing.

In addition, the distinction between the U.S. capital gains taxation and the international community capital gains treatment puts U.S. industry at a distinct disadvantage.

We compete in a global market with global competitors. We must reward the long-term investor, even if it is at the expense of short-term investment.

In summary, I believe you have the opportunity to help American business compete and succeed in an increasingly competitive global world.

And the payoff for taking these actions will be felt throughout the economy, from the paycheck created for an individual employee, to the tax revenues generated for the U.S. Government. The actions are simple and straightforward.

Please set in place permanent tax policies that encourage a long-term mentality amongst investors and corporations, and thereby create an ongoing source of capital for new companies, new ideas, and for new jobs.

Thank you for the opportunity to speak here today.

Senator BOREN. Thank you very much, Mr. McCracken.

[The prepared statement of Mr. McCracken appears in the appendix.]

Senator BOREN. Let me go back to a question that I asked our earlier panel. In terms of capital gains differential and holding periods, what do you think that the minimum holding period should be to again qualify for, I would assume, escalating differentials that would increase the longer the holding period? And what do you think the level of differential needs to be to begin to have a substantial helpful impact? Maybe we might begin with Mr. McCracken on that.

Mr. MCCRACKEN. Thank you. Well, it is my belief that what is really needed is long-term patient capital. And with that in mind, I believe a holding period of 3 years, or even 5 years is not out of the question.

I think anything that would encourage long-term capital would be of use to companies like ours, and new companies that have not yet been formed.

In terms of differential, obviously I would prefer the rate in Germany or Japan, but I understand that may not happen in the foreseeable future. Certainly I think anything in the 20 percent area or below would be quite helpful.

Senator BOREN. It needs to get down to as much as 20 percent or lower, you think, to have the impact it would need.

Mr. MCCRACKEN. I believe so.

Senator BOREN. Do any other wish to comment on this?

Dr. Chen.

Dr. CHEN. Generally, I agree. I think maybe the President's recent proposal is good. One year, 2 years, 3 years, with different reductions, except that AMT of 24 percent, I think, is a problem. So, we need to bring it below 20 percent.

Senator BOREN. Right. Right. Any other comments? Mr. Hatsopoulos.

Mr. HATSOPOULOS. Well, Senator, from the standpoint of the cost of capital and getting competitiveness between this country and

Japan, eventually we have to go to a capital gains rate of zero for equity.

And if we do that, it has to be on the basis of a long holding period. The reason is that we have had too much focus in public companies on quarterly earnings.

And if, right now, we were to say that you would get a very big advantage as an investor by holding beyond 3 years, or 4 years, or 5 years, you will find a different pressure on the part of the stockholder towards the managers of the public companies; asking the managers not what are you going to earn next quarter, but what are you investing now to earn 3 years from now when I am likely to sell my equity.

Senator BOREN. Right.

Mr. HATSOPOULOS. And, therefore, the whole issue of holding is very key if we are going to change the short-term orientation of public companies and move more towards that which they have in Japan or in Germany, which they achieve primarily because of different holding structure, which we cannot do in this country.

Senator BOREN. Right. Mr. Corry, any additional comments on that?

Mr. CORRY. I would say, Senator, that our tax affairs, in terms of competitiveness and our ability to compete with other companies that our in our businesses, that capital gains would not have the same priority——

Senator BOREN. No.

Mr. CORRY [continuing.] As capital cost recovery, for example.

Senator BOREN. So, AMT is more important.

Mr. CORRY. But I understand it is very important for small entrepreneurial capital and smaller businesses to have an attractive capital gains structure.

Senator BOREN. From your point of view, as a company that must, in order to compete, make huge capital investments all the time, AMT relief modification would be probably the top priority, from your point of view.

Mr. CORRY. Absolutely. We are sort of trapped, and I would like to give you one short example. You well remember the original purpose of the AMT and what stimulated its enactment.

Senator BOREN. Right.

Mr. CORRY. We had companies reporting a big book income, and somehow they were paying no taxes.

Senator BOREN. Paying no tax.

Mr. CORRY. There was trafficking in tax credits and that was well-intentioned. But we had, in 1990, for example, a rather good year. We made over $800 million of profit. We paid AMT.

We could not get ourselves, because of our capital investments and depreciation, into the regular tax structure. This year, we lost a lot of money. We are paying AMT.

So, we can hardly see a way to get out of it. Our investments have become a great trap and we are rather permanently locked in the AMT unless we can drastically cut our investments.

Senator BOREN. No matter how much you lose, you are still under the Alternative Minimum Tax, it would appear.

Mr. CORRY. Or, as it would appear last year, no matter how much we make, unless we change our capital investments.

Senator BOREN. Which, again, if you reduce your capital investments in the long-term, that is going to reduce your productivity and ability to compete.

Mr. CORRY. Certainly.

Senator BOREN. So you are trapped. The other three of you, is AMT a factor with the three of you at all? Not with Mr. Hatsopoulos. Is it with you, Dr. Chen—AMT?

Dr. CHEN. Well, the corporation paid a total, between Federal and State, about a total of 44 percent.

Senator BOREN. Forty-four percent on income?

Dr. CHEN. Yes. For the last several years.

Senator BOREN. Mr. McCracken, does AMT affect you at all at this point?

Mr. MCCRACKEN. No, sir.

Senator BOREN. On the question that has been raised about the border differential of some kind, let me go back to that.

And I apologize. I understand, Mr. Hatsopoulos, you talked about this as well, and I was over voting during that time.

But let me go back to the question and address it especially to you and to Mr. Corry—and I understand completely the merits of what is being discussed here in terms of consumption taxes—but let us suppose that we are not able to get our colleagues to make a change as dramatic as that in the tax system, so we are still limping along with band-aids on our current conceptual approach.

Is there a way, given our current situation, of putting a GATT-legal border differential in place that would help us in terms of exports and import balance?

Mr. HATSOPOULOS. Well, I understand that VAT—are you talking about a VAT tax across the border?

Senator BOREN. I suppose we could.

Mr. HATSOPOULOS. A VAT is employed by many countries.

Senator BOREN. Sure.

Mr. HATSOPOULOS. And it is approved by GATT, so there is no problem. I would like to make a point, however, on the VAT, because Marty Feldstein said that a VAT does not help—I mean, a tax reimbursed at the border does not help the trade—and I differ with him.

I differ with him on basic economic issues. He said that if you have that, all it will do is have the same trade deficit at a higher dollar.

That is true, but if we are going to have a trade deficit, we want to have it at the highest possible dollar, because then we can buy more assets abroad than they can buy in this country.

So, from a national interest point of view, I fully understand with him that the trade deficit is defined, not by whatever your taxing is, it has to obey the difference between investment and saving.

What is left over has to be a trade deficit. And that is why our focus is to get the savings up in order to reduce the trade deficit. But I differ with Professor Feldstein's approach that the VAT does not benefit us.

Senator BOREN. Let me ask one other question. Dr. Chen, I know you accompanied the President to Japan. We had a lot of discussion after that trip about the methods of executive compensation, and some of you have talked also about the fact that you have incen-

tives for all employees to buy stock, to become partial owners of the company.

It has often been said the more we can identify management's interest with the same interest as ownership in forms of compensation, that this helps performance of companies.

Do you have any thoughts on how we can encourage executive compensation that would be related both to the performance and the common interest with stockholders and owners of companies?

Dr. CHEN. Well, in our company, we have a relatively low base salary. The executive bonus is strictly based on the company's financial performance against a certain target, and it has been working very well. And I think that is the way to go.

Now, of course, the difference in compensation between the executives here and Japan at some big interest in Japan, I think there is some problem in this country, but, personally, I do not think it is the biggest problem. There are some executives that get paid off the scale, particularly when their companies are not making money and the stock is going down.

But, I believe in this country one of the major problems, from my standpoint, is, particularly in the big companies, the executives take the leadership in quality and competitiveness.

And even government and public sectors really can probably use something from Malcom Baldridge Award criteria for self-assessment.

Senator BOREN. Yes. Some people have pointed out to me that many of our companies are now having to go through this very painful experience, larger companies, especially, of shrinkage, in order to survive.

And I have had the question put to me, when will the agencies of government attempt to do the same thing, have the same level of productivity of services while having some shrinkage?

And it is a very interesting question, and I think we very much need to grapple with that. One of our problems is that Congress micro-manages to the degree that it would be very rare for us to say to an agency head, now, we are going to let you, if you wish, increase some compensation, give some bonuses to people who are performing or do other things, but you have to pay for it out of scaling down unproductive units of your own operation in order to do it with the same amount of money you have.

We are going to give you the same budget next year you have got this year. We will let you pay some increases in salary, we will let you do some other things, but you have to find a way to find your own flexible structure for doing so.

We have never experimented with that. Maybe it is something we should think about in government as well, and learn from some of the companies that are having to go through some scaling down in order to be leaner, but more efficient and more productive.

And it is something we need to think about. I think your point is very well taken, that we have not had the kind of leadership from government; we certainly have not had the permanence of tax policy.

I think the comments about the R&D tax credit, for example, are absolutely right. How in the world can you encourage long-term investment decisions and cutting edge technologies when you do not

know what the rules are going to be 24 months from now, or 12 months from now. It is a very important question.

Mr. McCracken, any thoughts that you might have on the executive compensation question?

Mr. McCRACKEN. It is an important issue. Just a point on the small companies. As we form small companies in high-technology, we quite often pay very low salaries, and, as a result of that, make up the difference in terms of stock options.

And that is why people join these job-creating kind of small companies. In fact, in my own personal case, I left a large company to join Silicon Graphics and took a 60 percent pay cut in the process.

But, of course, that was balanced against the chance to create something out of nothing. And it is human capital in addition to financial capital that is important in these small companies.

I think the important thing is that executive compensation should go down when company performance goes down. I think the American people are sensitive when companies have poor performance and executive compensation goes up.

Senator BOREN. Well, I appreciate very much the comments that all of you have made. I think the testimony is very helpful.

I gather you all would agree with the comments made by our economists that, while there may need to be some package for short-term stimulus in order to restore confidence in the economy, you think this should be within reasonable bounds as it impacts the deficit.

And, within bounds, it would leave room for us to look at some of the longer term changes that need to be made.

Capital gains has some virtue of being a bit of both. I think it would cause some turning of assets that would create some short-term stimulus, but it also relates to the long-term question—as does AMT, certainly in terms of the differentials of cost of capital.

Would that be a fair statement, that you would want us to keep whatever short-term stimulus package we do within enough of a boundary that we could then look at these other longer term tax changes as well?

Mr. CORRY. Yes.

Mr. HATSOPOULOS. Yes.

Dr. CHEN. Yes.

Mr. McCRACKEN. Yes.

Senator BOREN. Thank you very much. I apologize that we were interrupted by the vote, and that our discussions have gone on so long. But this has been a very enlightening session.

When you hear the comments that have been made today about the level of investment in this country and the penalty we attach to what we most need—saving and long-term investment in this country right now, greater levels of investment in our capital-intensive industries—it should frighten all of us into action.

Because we are in a position—and I recall the statement that Dr. Feldstein made—that possibly, given the depreciation of our aging equipment in our country and given the levels of investment, we may be at a negative net investment position, or very close to it.

What that means for the future of this country, and future jobs for our children and grandchildren is frightening.

And I tend to think that while the American people are under great stress and they are concerned about the current economic circumstance, that what they have seen, especially in the restructuring of the major companies of the country—the companies that people felt would always be there, and always be as large as they are, and always have as many employees that they have had—that this, perhaps, is doing even more than the short-term stress to cause people to be anxious.

And I think unless we are prepared to see a lot more of this happen in our economy, we must think long-term. We have to put in place some of these changes. We must change capital gains.

We must change this very punitive Alternative Minimum Tax as it is now written and look to the long-term.

And I think we underestimate the good sense, the judgment, and the understanding of the American people to think that they would choose a short-term check of a very small amount, that they are so short-term in thinking, that they would take that in preference to changes in the Tax Code that would really assure jobs and an economic future for them.

I think we underestimate the intelligence and the good sense of the American people when we, as politicians, think that we always have to react principally in the short-term and not in the long-term.

I think the people understand it, and I think that they are wanting to see us adopt an economic strategy and a blueprint for the future that makes sense and that calls upon some short-term sacrifice.

So, your testimony certainly leads us in that direction, and I appreciate all of you being with us very much.

Mr. CORRY. Thank you.

Mr. HATSOPOULOS. Thank you.

Dr. CHEN. Thank you.

Mr. MCCRACKEN. Thank you.

[The hearing was concluded at 5:00 p.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR DAVID L. BOREN

At the outset, let me welcome my colleagues and the distinguished panelists and open this hearing on long-term tax policy and the tax system's effect on the cost of capital and the ability of U.S. businesses to compete internationally.

Today we embark on what I hope will be a series of hearings before the Subcommittee on Taxation that will focus on the long-range objectives that should guide any of our efforts to reform the present tax system. Such a structural analysis is always timely and important because we must be mindful of long-range planning goals as we determine the proper direction for legislative change.

These hearings, and the ideas they engender, have become particularly crucial in the past few days. During the next several weeks, the Congress and the President will be working together to craft an economic growth package, which is certain to include tax incentives and other changes in the tax code. In this atmosphere of preoccupation with short-term problems and solutions, it is imperative that we act in ways that are consistent with long-range objectives. Thus, while this hearing is not intended to provide a forum for a discussion of the specific proposals currently before Congress, this context necessarily affects our proceedings today.

I have never believed that the tax code can be—or for that matter, should be—neutral in an economic sense. The tax system inevitably will encourage some types of economic behavior, while discouraging other activities, because its provisions interact with the distribution of limited resources in the economy. This economic fact of life is not disturbing. Indeed, Congress has the responsibility to use the legislative tools at its disposal to guide the economy and the country in ways that benefit our citizens. The tax code is one of the most powerful of those tools.

Given the impossibility of neutrality, we must be very aware of the tax system's effects on investment and productivity—two key factors for economic growth, employment and this country's ability to remain a world leader. I have become increasingly convinced, however, that our tax system actually discourages investment and actively impedes our ability to compete in the world marketplace.

For example, it has become apparent that the cost of capital for U.S. businesses is substantially increased because of the tax burden on capital assets. The increased cost of capital has in turn decreased our ability to compete against our major trading partners. A study by Arthur Anderson demonstrated that after five years, a U.S. corporation paying the regular corporate tax recovers 77 percent of the original cost of a factory robot, and a U.S. corporation paying the alternative minimum tax recovers 37 percent of this cost. This last figure may well be the most relevant one in light of estimates that about half of this nation's businesses may be it payers in 1991. These figures compare unfavorably with the capital recovery rates of other countries: businesses in Korea recover 106 percent of their capital costs for such equipment, and German companies recover over 81 percent.

It is clear that we must think internationally when we consider tax policy. We cannot afford to write our tax policy in a vacuum. We must consider how it relates to the tax policy in other nations with whom we must compete in world markets.

This hearing allows us the opportunity to explore these issues with the expert panelists present today. Professors Feldstein and Shoven have produced a wealth of scholarship on these issues and are here to share their innovative ideas and perspectives with us. In addition, we will talk with four business leaders who participate actively both in the domestic economy and the international markets. They are aware on a day-to-day level that the tax code influences their business decisions and their ability to compete with their foreign competitors. By focusing on these issues from theoretical and a practical perspectives, we can begin the process of determin-

ing the proper long-term goals for the tax system, and we can start to construct a tax code that better serves these objectives.

PREPARED STATEMENT OF CHARLES A. CORRY

My name is Charles A. Corry and I am Chairman and Chief Executive Officer of USX Corporation. I'm grateful for the opportunity to address the committee on a topic that is so important to our country's economic health. USX Corporation operates primarily in the integrated energy and steel industries. Our 1991 sales of nearly $19 billion should rank us within the top 25 industrial companies in the United States.

Our Marathon Group represents approximately 70% of USX Corporation's total sales. It is the ninth largest integrated oil and gas company in the United States with exploration and production activities in 17 countries around the world. In 1991, foreign production represented more than one-third of Marathon's worldwide crude oil and natural gas production.

Our U.S. Steel Group is the largest integrated steel producer and the largest steel exporter in the United States. Over the past two years we have exported an average of over 1 million tons per year, or just over 11% of our total shipments, to countries such as Japan, Korea, Canada and Mexico.

Both our energy and steel businesses are capital intensive and face strong foreign and domestic competition. The tax laws of the United States have a critical bearing on our ability to compete in the world markets.

Tax Issues

We are very concerned about the direction that tax policy has taken in this country since 1982. Tax legislation since that time has been revenue driven with little consideration given to effects on international competitiveness even though our markets and our competitors are global. As a result, our current tax law is anti-competitive and gives our foreign competitors a distinct advantage. We believe the adoption of a broad-based border adjustable tax as a substitute for the current income tax system, or as a means to obtain revenue to improve the current income tax system, is essential to the economic well-being of this country.
Today, I will review some specific examples of the impact of current and proposed tax policy on USX's energy and steel operations. The tax areas I will focus on include:

The Adverse Impact of the Alternative Minimum Tax (AMT)

The Tax Treatment of Mandated Environmental Expenditures

Energy and Environmental Taxes

Border-Adjustable Taxes

Adverse Impact of the Corporate Alternative Minimum Tax

One of the most anti-competitive aspects of current tax law is the alternative minimum tax, or AMT, which went into effect in 1987.

Prior to 1987, the cash flow effect of federal income taxes tended to be counter-cyclical. Taxes adversely impacted corporate cash flow as taxable income increased and had a positive impact in loss years due to the ability to carry losses back to prior years and receive a current refund.

This relationship changed drastically as a result of the AMT. What we now face is a tax system which is pro-cyclical in that it amplifies the negative cash flow effect of a recession on companies, thereby leading to slower economic recovery.

The AMT was designed to insure that corporations with substantial economic income would not be able to avoid significant federal income tax liability. With the perception of fairness as an overriding objective, Congress did not sufficiently focus on the perverse impact the AMT would have on marginally profitable, capital intensive companies and especially those which operate in cyclical industries such as energy and steel.

Our 1991 results provide a dramatic example of the impact of the AMT on corporations such as USX. In 1991, on a reported earnings basis, USX lost $578 million and incurred a substantial loss for regular income tax purposes.

Prior to enactment of the AMT in 1987, the tax effects of this substantial loss would have been as follows:

- USX would have paid no current taxes;

- Our substantial net operating loss would have been carried back to obtain a refund of taxes paid during the prior three years; and

- Any remaining net operating loss would have been available as an offset to 1992's or future years taxable income.

Due to the AMT, however:

- USX will receive no current refund against prior years taxes;

- Even with our significant reported loss and regular taxable loss, USX will pay Alternative Minimum Taxes for 1991; and

- Realization of tax benefits associated with our substantial 1991 regular taxable loss will be deferred until we incur regular taxes in excess of the AMT.

We feel that this perverse impact was clearly not the original intent of Congress when it enacted the AMT.

Since our acquisition of Marathon Oil Company in 1982, for financial purposes, USX Corporation has incurred a cumulative loss of $273 million yet we have paid over $200 million in AMT.

The most significant cause of USX paying this $200 million in alternative minimum taxes was the minimum tax depreciation preferences arising from our capital investment of nearly $6.6 billion during the period 1987 through 1991.

In order to continue modernization of our manufacturing facilities, to comply with requirements of the new clean air legislation and to enhance our worldwide oil and gas reserve base, USX's capital expenditures will need to continue at high levels. These high levels of capital expenditures are likely to result in USX remaining subject to the AMT for the remainder of this century.

Specific Impact on USX's Capital Investment

We are currently installing a continuous caster in the one remaining steel producing plant we have in the Pittsburgh area at a cost of over $250 million. This caster is needed to reduce operating costs and improve the quality of our product in order for us to continue to be internationally competitive.

A new study prepared by Arthur Andersen & Co. was discussed as part of recent testimony before the House Committee on Ways and Means by the American Council for Capital Formation. That study confirms the capital recovery disadvantage imposed on companies subject to the AMT. We suffer a capital recovery disadvantage not only against our major foreign trading partners, but also against our domestic competitors who pay regular corporate income tax. Such a capital recovery disadvantage on projects such as this continuous caster negatively impacts our cash flow and cost of capital, placing us at a competitive disadvantage in world markets. If this Committee is interested in improving the ability of capital intensive companies such as USX to compete in the world marketplace, we need to dramatically improve the capital recovery provisions under the AMT.

Administrative Burdens

Another costly aspect of the corporate minimum tax is the tremendous administrative burden it imposes. It is an additional parallel tax system. Prior to the Tax Reform Act of 1986, corporations needed to calculate only financial and tax depreciation. The minimum tax requires two additional depreciation calculations - regular minimum tax depreciation and adjusted current earnings (ACE) depreciation. When assets are sold, the gain or loss must also be calculated on four different bases.

Another complexity imposed by the minimum tax relates to inventories. A few years ago, we had one LIFO system that was used for both financial and tax reporting. As a result of 1984 and 1986 tax reforms, we had to develop two additional inventory systems - one for regular income tax and one for the minimum tax. For 1990, we had to add two more systems - one to adjust for ACE depreciation plus a FIFO system to obtain the ACE LIFO Recapture amounts. As a result, we now need five inventory systems instead of the one system in place prior to tax reform. To prepare our 1990 federal income tax return, the accountants at our steel plants worked 30 man-weeks of overtime just to develop the FIFO inventory values, and then our headquarters personnel spent additional time processing the data. Because of the complicated nature of these calculations, some of our best people are assigned to these tasks rather than directing their efforts toward improving production and the quality of our products.

Senator Boren's AMT Credit Proposal in Bill S.2159

The depreciation provisions of the AMT keep many capital intensive companies indefinitely in the AMT, precluding the use of accumulated AMT credits against regular tax liability within a meaningful time frame. Senator Boren's Bill S.2159 provides a significant solution to the deferral, or inability to use AMT credits, by permitting taxpayers with certain unused minimum tax credits to offset up to 90% of the total

of current year regular and net minimum tax liabilities. While we still prefer long-term solutions to the AMT capital recovery provisions, this kind of action is what is needed to make U.S. companies more competitive.

President Bush's State of the Union Address Proposals

We applaud President Bush, in his January 28 State of the Union Address, for recognizing the negative impact that current capital recovery and alternative minimum tax provisions have had on capital-intensive, marginally-profitable industries like ours. While our analysis of President Bush's specific proposals indicates that enactment would have a minor temporary beneficial impact, the proposals do not provide a long-term, meaningful reduction in our cost of capital or improvement in cash flows. The beneficial impact of the President's proposals to USX would be equal to less than 1% of our capital spending budget for the next two years, and therefore would not be sufficient to affect our investment decisions.

Tax Treatment of Non-Productive Government Mandated Expenditures

The Environmental Protection Agency estimates that the domestic steel industry faces up to $5 - $6 billion in additional costs to comply with new standards for air toxics under the 1990 Clean Air Act amendments. We must utilize scarce capital funds for these and other government mandated non-productive projects, which severely restricts capital available for improving our competitive position. I am not here today to debate the Clean Air Act's requirements. However, the immediate expensing or enhanced depreciation of pollution control facilities would reduce the cost of capital for these expenditures and help eliminate the cost advantage of those foreign competitors that are subject to less stringent pollution control standards. At a minimum, there should be no depreciation preferences on pollution control equipment for alternative minimum tax purposes.

Under Senator Boren's Bill S.2159, AMT depreciation preferences will not be calculated for environmental improvement assets. This is a step in the right direction.

Energy and Environmental Taxes

In addition to the AMT, we are deeply concerned over proposals of higher energy and environmental taxes which would jeopardize the ability of U.S. industry to compete internationally. These proposals would have anti-competitive impacts far beyond what energy tax proponents may realize. Imposing higher energy taxes will put U.S. manufacturers, including USX, in a dangerous international competitive position.

During negotiations on the 1991 Federal Budget, Congress looked at a variety of energy and environmental taxes as potential revenue sources. These proposals included an increase in the motor fuel tax, a new BTU tax, taxes on "virgin" materials, new ad valorem energy taxes and a carbon energy tax. Fortunately, other than a five-cent per gallon increase in the motor fuel tax, none of these proposals were enacted. We wish to re-emphasize our opposition to any renewed consideration of energy tax initiatives for the following reasons:

Competitiveness

Energy taxes on U.S. manufacturers would be highly anti-competitive because they would result in increased costs to U.S. industry, without impacting foreign firms that compete with American products in both domestic and international markets. This is particularly evident in our company given the industries in which we operate. USX is somewhat unique in that we are both a substantial consumer and producer of energy resources. The steel and oil industries will each be severely impacted by increased energy taxes of any kind.

Over the past decade, the domestic steel industry has dramatically improved its competitiveness through painful restructuring and substantial improvements in productivity. In fact, the industry is becoming well-positioned to compete effectively in the world marketplace. However, its ability to maintain this progress is already under severe pressure due to new environmental costs and other external factors beyond our control. Since the steel industry is the largest industrial consumer of energy in the U.S., new energy taxes would add a further heavy burden to the total cost structure and virtually wipe out years of competitive improvement in a matter of months. Further, they would exhaust nearly all funds for continued modernization as none of the increased energy costs could be recovered in the marketplace due to foreign competition.

The impact of increased energy taxes on the oil industry, including our Marathon Group would also be severe. The oil industry likewise faces substantial cost increases from new environmental legislation and other pressures which will divert capital resources from exploration for and development of new sources of secure oil production. Increased energy taxes will further reduce cash flow and substantially weaken the ability of U.S. oil companies to compete in the international petroleum marketplace. Competition for sources of petroleum reserves throughout the world is intense, and requires a great deal of capital resources for exploration and development activities. Energy tax cost diversions will impede the oil industry's ability to maintain an adequate supply of petroleum products and further injure the competitiveness of our nation's energy-intensive industrial economy.

Disproportionate Impact on Certain Industries and Regions of the Country

All broad-based energy taxes would disproportionately impact producers of energy, such as our Marathon Group, and industries such as our U.S. Steel Group that are heavy users of energy. States with heavy industrial energy users would also be disproportionately affected.

Negative Revenue Impact

A 1990 study prepared by the National Association of Manufacturers concludes that the ripple effect of new or increased energy taxes would actually result in less U.S. economic activity and a net decrease in tax revenues.

Impact of Energy Taxes on USX

Regardless of the specific form a broad-based energy tax may take, the cost impact on our Corporation would be substantial. Whether tax would be calculated on a BTU, ad valorem, or carbon content bases makes little difference as to the effect on our relative cost structure and resulting competitive position.

Border Adjustable Taxes - A Key to U.S. Competitiveness

We are convinced that our present tax system must change if U.S. industry is to be world competitive. Virtually all of America's major trading partners already have a border-adjustable tax that is levied on imports and rebated on exports.

Under the current tax system, USX's export sales are taxed twice. We are subject to U.S. income taxes on products manufactured here, and a value-added tax is imposed by most of the countries to which steel products are shipped. However, when a foreign steel producer sells to customers in the U.S., its sales are exempt from their value-added tax and there is no comparable U.S. tax imposed on these imports.

The adoption of a properly constructed border-adjustable tax would help put domestic industries on a more equal tax footing with most of our foreign competitors. Such a tax would have a further positive impact as it would apply to imported products and foreign companies which now largely escape U.S. taxes altogether.

Uniform Business Tax

We support the general concepts of Congressman Schulze's Uniform Business Tax (UBT) proposal which would replace the present corporate net income tax and the employer's share of FICA taxes.

This type of broad-based, border-adjustable tax would generate an estimated $50 to $60 billion in additional revenues from our foreign competitors and would result in a simpler U.S. tax system. Its provisions of immediate expensing of new plant and equipment are key elements in reducing the cost of capital.

We view the UBT as a notable first step in facilitating the discussion and debate about what kind of business tax system this country should move toward in order to eliminate most of the anti-competitive aspects of the present system. However, like any initial version of a revolutionary concept, the UBT is not yet perfect. The concepts and specific provisions are in an evolutionary stage and will require additional thought and careful analysis for continued improvement.

A Sense of Urgency is Needed

While such bold changes to our tax structure must be carefully considered, the increasing prevalence of border-adjustable consumption taxes among our major trading partners requires that Congress not delay its consideration of the adoption of a broad-based, border-adjustable tax.

Using Border-Adjustable taxes to Improve the Current U.S. Tax System

If a complete replacement of the current corporate income tax system with a border-adjustable type tax as envisioned by the UBT is not feasible, then we should consider the adoption of some other form of border-adjustable tax. The revenues from any new tax must be used to provide capital formation incentives and to eliminate or substantially reform the AMT. In order to improve the competitive position of U.S. businesses, revenues from a border-adjustable tax must not be used for additional spending.

Thank you for the opportunity to present the views of USX Corporation.

PREPARED STATEMENT OF MARTIN FELDSTEIN*

Summary

The first part of this testimony discusses the use of tax policy to stimulate a stronger economic recovery. The second and third parts discuss long-term tax reforms to increase business investment and the taxation of capital gains.

A new analysis, summarized in the fourth section, shows the importance of recognizing the effect of IRAs on corporate tax revenue: a back-ended IRA can increase national saving with no loss of total tax revenue in any year.

Tax Policy and Economic Recovery

(1) The economy is likely to be expanding briskly by the summer if not before. The sharp reduction in interest rates that the Fed caused in late December will stimulate home building, will increase spendable cash by reducing monthly mortgage payments, and will increase exports and reduce imports by making the dollar more competitive. The rise in the stock market that followed the Fed's actions will increase total household spending and encourage increased business investment.

(2) This strengthening of the economy would be threatened by continued slow growth of money and credit. To offset last year's very slow money growth and support healthy growth in the year ahead, the Federal Reserve should aim to increase the broad monetary aggregate (M2) by about 6 percent this year. This would be equivalent to 4.5 percent money growth from where M2 should have been at the end of 1991 (i.e., up 4.5 percent from the year before) rather than from the lower level at which M2 actually ended the year.

(3) If the Fed does seek such growth of money and creait, a large tax cut to stimulate the economy would be inappropriate. The resulting stimulus to demand would probably not arrive until the strong expansion was already under way. It would then be unnecessary and would risk overstimulating the economy, causing a rise in inflationary pressure that would have to be offset by a tightening of monetary policy. Enacting a major tax cut would also frighten financial markets, with the possible result of higher long-term interest rates and a depressed stock market. Reversing an overly expansionary fiscal policy is far more difficult than reversing an overly expansionary monetary policy.

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*The opinions expressed in this testimony are my own and do not represent the views of any organization.

(4) Any tax cut that is considered as a way to stimulate the recovery should be judged by balancing the short-term stimulus against the long-term consequences for the national debt. An increase in the national debt is disadvantageous not only because it may crowd out private investment immediately but also because paying the interest on the debt year after year in the future requires higher levels of taxes that will distort work effort and other economic activity.

(5) The President's proposal to speed up spending on public infrastructure is a desirable way to stimulate the economy because it can occur quickly and does not cause any additional permanent increase in the national debt. An investment tax credit (ITC) is desirable because private spending responds quickly and rises by more than a dollar for every dollar of revenue loss. An incremental ITC or the substitution of a low-interest investment loan can be even more cost-effective in stimulating spending at low revenue cost.

(6) An election year is not likely to be a good time for enacting permanent tax changes because the pursuit of electoral favor may result in expensive tax cuts with little or no favorable effects on incentives to work, save and invest. I regard the various proposals for tax credits or increased tax exemptions as examples of this undesirable category.

(7) If there is to be a "middle income tax cut," I think the best option would be to bring back the second earner tax deduction (that was eliminated in the 1986 tax legislation) but modified so that the full benefit is limited to those with family incomes below $75,000. Such a plan would give a tax break to about 30 million middle-income taxpayers and would have good supply-side effects by lowering marginal tax rates on a particularly sensitive group. The traditionally estimated "static" revenue cost would be about $6.5 billion although the feedback effect of increased labor supply in this group would cut that cost approximately in half. (See "The Right Kind of Tax Cut," *Boston Globe*, December 31, 1991, attached.)

Long-term Tax Reform: Business Investment

(8) Although there were many good things about the 1986 tax legislation, in retrospect we can also see many faults. After seven years it will be time in 1993 to look again at fundamental issues of tax reform.

(9) An important theme in the 1986 debate was "leveling the playing field" among alterative investments. In principle, a level playing field avoids the reductions in productivity caused by tax distortions in the use of capital and labor. In practice the playing field was only leveled among different types of tangible business investments. Eliminating the investment tax credit and lengthening the depreciation period actually widened the distortion between investments in tangible business capital and other forms of spending, thereby favoring spending on advertising, temporary price competition to enlarge market shares, and household spending on first and second homes and major consumer durables.

(10) This committee should return in 1993 to reexamine the investment incentives embodied in our current tax code. I believe that some form of permanent ITC or accelerated depreciation would increase investment and raise productivity. It would also be more faithful to the general principle of seeking a level playing field than the partial reforms of 1986.

Long-term Tax Reform: Capital Gains

(11) A reduction of the rate of tax on capital gains would reduce the cost of equity capital, particularly for risky investments. This would assist not only new businesses but also new ventures within existing business. It would favor research and development activities and the development of new products that require patient risk-tolerant capital.

(12) These favorable effects are probably the primary reasons why most other countries tax capital gains at very low rates or do not tax capital gains at all. There is also widespread agreement that it is unfair to tax the appreciation of asset prices that is due only to inflation.

(13) The only legitimate justification for not reducing the tax on capital gains would be that there would be such a significant revenue loss that the adverse effect of the resulting budget deficit (or increase in other taxes) would outweigh the favorable effect of the lower capital gains tax. Although there are difficulties in estimating the revenue effect of a capital gains tax cut, I believe after a careful analysis of the evidence that a substantial reduction of the capital gains tax rate would not cause a significant revenue loss and might well increase total revenue.

(14) If there were no behavioral response by shareholders, reducing the capital gains tax rate from 30 percent to 20 percent would automatically cut revenue by one-third. Economic studies leave no doubt, however, that the lower tax rate would increase capital gains realizations (in the long-run as well as in the short-run) and that such increased realizations would produce a substantial rise in capital gains tax revenue to set against this static revenue loss.

(15) The Congressional Budget Office has estimated that the behavioral response of increased realizations would offset about 80 percent of the static revenue loss, leaving a relatively small net revenue loss. The Treasury staff has estimated that the increased realizations would offset about 110 percent of the static revenue loss, leaving a small net revenue gain. Economic analysis is simply not precise enough to choose between these two estimates: that is, between a behavioral response equal to 80 percent of the static revenue loss and a behavioral response equal to 110 percent. A cautious reading of the evidence would conclude that the increased realizations leave no net revenue effect but would acknowledge that there is uncertainty about this estimate in both directions.

(16) These estimates, as well as those that the Joint Committee Staff has prepared for the Congress, do not take into account the favorable effect of a lower capital gains tax rate on economic growth and the resulting increase in personal and corporate tax rates. Although it is difficult to estimate the magnitude of this effect, it is certainly positive. Even if the increase in GNP growth was as little as 0.05 percent a year (e.g., from 2.50 percent to 2.55 percent), the additional personal and corporate tax revenue would outweigh the revenue loss estimated by the Joint Committee Staff by the fourth year and be three times as large within a decade.

(17) I believe that lowering the maximum capital gains tax rate to 20 percent would almost certainly increase total tax revenue. It would make the economy better off without making anyone worse off. It is difficult to see how such a tax cut can be justifiably rejected. A 50 percent capital gains exclusion might also be worthwhile even if it lost a small amount of revenue because of the favorable overall economic effects.

Long-Term Tax Reform: Saving Incentives and IRAs

(18) The key to increased long-term investment in plant and equipment is a higher national saving rate. Our current low rate of national saving means a high cost of capital, a low level of investment in plant and equipment, and therefore a low rate of increase of productivity, incomes and our standard of living.

(19) Unfortunately, the private saving rate collapsed in the 1980s. Net saving by households and businesses fell from an unacceptably low level of only about 6.5 percent of GNP in 1980 to only 4.0 percent of GNP in 1990. The federal government's borrowing to

finance the structural budget deficit of about $190 billion this year will absorb about three-fourths of these savings, leaving virtually no net saving to finance investment in equipment, business structures and housing.

(20) During most of the 1980s, such fixed investment was sustained by the inflow of capital that accompanied our trade deficit. But the trade deficit has been declining and with that decline comes a parallel decline in the capital inflow available to augment our domestic savings. While the capital inflow was enough in 1987 to finance investment equal to 3.5 percent of GNP, in the current year the corresponding capital inflow will be only about one percent of GNP. Looking ahead, the inflow of foreign funds will not be able to offset a low saving rate. We must increase our national savings or suffer the consequences of low productivity growth.

(21) The fall of the saving rate in the 1980s reflects several things including the increased value of the stock market and the increased net-equity in individuals' homes, the introduction of home equity loans and the spread of credit cards, and the reduced rates of growth of income and profits.

(22) The Individual Retirement Accounts (IRAs) had a favorable effect on saving (although not a large enough effect to offset the unfavorable factors just noted.) Careful statistical studies show that of each extra dollar added to an IRA only about 30 cents would otherwise have been saved. The remainder comes from a combination of reduced consumption and lower tax payments. Since the tax reductions per dollar of IRA contribution cannot exceed the maximum marginal tax rate, the evidence implies that the IRA increases savings by more than the fall in personal tax revenue. Even if IRAs reduce revenue, the evidence clearly implies that IRAs raise national saving.

(23) The method used by the staffs of the Treasury and the Joint Tax Committee to estimate the revenue effects of IRAs substantially overstates the revenue loss and understates the gain in national saving because it ignores the effect of the increased saving on corporate tax revenue.

(24) The additional saving in IRAs increases the stock of business capital. The resulting profits increase corporate tax revenue which offsets part of the decline of personal tax revenue that results from the deduction of IRA contributions. According to my calculations, within ten years these additional corporate tax revenues can more than offset all of the annual loss of personal tax revenue that results from a traditional deductible IRA. (See Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," 1992).

(25) Taking the corporate tax revenue into account has even more important implications for a "nontaxable" (or "back-ended") IRA that would allow no deduction of each year's contribution but that would permit all of the accumulated funds to be withdrawn at retirement age without paying any tax.

(26) The Treasury and Joint Committee method of revenue estimation implies that such a nontaxable back-ended IRA would cause a revenue loss because some of the interest, dividends and capital gains earned in IRAs would otherwise have been earned in a taxable form.

(27) My study indicates that the additional corporate tax revenue that results from a nontaxable (or "back-ended") IRA is likely to be large enough to offset the loss of personal tax revenue in every year. The total net revenue effect of a nontaxable back-ended IRA would therefore be favorable in every year. There would be no increases in the deficit to offset even part of the rise of personal saving. A nontaxable back-ended IRA would unambiguously increase national saving in every year.

(28) The nontaxable IRA would provide the same net reward for saving as the original deductible type of IRA (unless the individual's marginal tax rate will decline after retirement). Indeed, by contributing less to the nontaxable IRA than he or she would contribute to a deductible IRA, the individual could have the same after-tax funds available for consumption now and in the future as would have resulted from a deductible IRA. The nontaxable IRA would thus provide a higher rate of return than the type of nondeductible IRA that is currently available to middle income and upper income individuals in which the accumulated interest is subject to tax when the funds are withdrawn. If a nontaxable back-ended IRA were available, savers would quickly learn that it was as valuable as an old-style deductible IRA.

(29) When I appeared before this committee in 1978 to discuss the reduction in the capital gains tax, the method used by the Treasury and the Joint Committee staff to analyze changes in capital gains taxation took no account of the likely effect on shareholder behavior. The static revenue effect implied large revenue losses from reducing the very high capital gains rate that prevailed at that time. Pressure from this Committee and from the Ways and Means Committee eventually convinced the staffs of the Treasury and the Joint Committee to modify their method to give a more accurate picture of the revenue effect of capital gains taxation. Now neither the Treasury nor the Joint Committee staff would think of analyzing the revenue effect of a change in the capital gains tax without including the offsetting effects of capital gains realizations.

(30) I think it is very important to modify the staffs' current method of estimating the revenue effects of IRAs to take into account the favorable impact on corporate tax receipts. A correct assessment of the total revenue effect is necessary not only to guide your personal assessment of the desirability of changing the IRA rules but also because of the central role that the estimated revenue effects play under the prevailing budget agreement. If the revenue effects of the nontaxable back-ended IRA were correctly estimated, the favorable net impact on total revenue would be an incentive to its adoption under existing budget rules.

THE BOSTON GLOBE
Tuesday, December 31, 1991

The right kind of tax cut

MARTIN FELDSTEIN AND KATHLEEN FELDSTEIN

IT LOOKS LIKE A GOOD BET THAT PRESIdent Bush will lend his support to a tax cut aimed at middle-income voters. Whether or not such a tax cut makes economic sense right now, the political pressure to match Democratic tax cut proposals may well become compelling. As the administration weighs the options in preparation for a possible announcement in the State of the Union message, it should pay special attention to tax changes that carry the right kind of incentives.

If there is to be a tax cut for middle-income voters, the best option would be to bring back the special income tax deduction for second earners that was abolished in the 1986 tax legislation. Reviving this tax rule would not only put money directly into the pockets of individuals who would spend it, but would also reduce the effective marginal tax rate faced by the second earner in the family.

Before the second-earner deduction was abolished, working couples subtracted 10 percent of the earnings of the lower earner's wages (up to a limit of $3,000) in calculating their taxable income. To see how this worked in practice, think about a couple in which one earns $30,000 and the other earns $22,000. The couple could deduct $2,200 (10 percent of the lower earnings) in calculating its taxable income. Since the couple faces a 28 percent marginal tax rate, reducing taxable income by $2,200 would mean a tax saving of $616 a year.

If the goal is to give as much as possible of the tax cut to middle-income taxpayers, the old rule could be modified so that only couples with combined incomes of less than $75,000 receive the full deduction, with a gradual phase-out leaving no deduction for those with incomes exceeding $100,000. With that modification, more than 85 percent of the tax cut would go to taxpayers with incomes of less than $75,000.

The extra attractive feature of this proposal, in contrast to others being discussed, is that it reduces the effective marginal tax rate for the second earner. Since 10 percent of income wouldn't have to be counted for tax purposes, the effective marginal tax rate of the second earner in our example would be reduced from 28 percent to 25.2 percent. Even with the deduction limited to $3,000 (or less for those with family incomes of more than $75,000), nearly 95 percent of second earners would face a lower marginal tax rate. In contrast, the other proposals that have been floated by both Democrats and Republicans are generally lump sum rebates or tax credits that do not reduce marginal tax rates and therefore do nothing to reduce the tax wedge that discourages work effort.

Reducing the existing tax disincentive to work is especially important for the second earner in a family. There is a reliable body of economic research that shows second earners to be much more sensitive to marginal tax work. The cut in the effective marginal tax rate would lead to increased working hours and earnings among married women.

This favorable effect on the labor supply of second earners is not only desirable in its own right, but also reduces the total budget cost of the tax cut without diminishing its stimulative effect on spending. While a traditional static revenue estimate that ignores the effect of increased earnings would imply a $6.5 billion revenue loss, reasonable estimates of the induced increase in labor supply would cut that cost in half.

Of course, the favorable revenue feedback would take time to be fully effective and would be temporarily reduced by the weak state of the economy. But even before there is any change in work habits, the second-earner tax deduction is a way to target the tax break on those middle-income taxpayers who are hardest pressed to make ends meet. An extension to another financial hardship group – single-parent taxpayers with school-age children – would also be worth considering.

While the prospect of the tax reduction and of the ability to earn more money by extra work would lead some households to spend more immediately, the tax reform could give an even stronger short-run boost to the economy by applying the second-earner rule retroactively to 1990 incomes and giving immediate rebates to those who qualify.

It is, of course, not clear whether such an extra boost is needed now that the Fed has given the economy the benefit of a sharp drop in interest rates. Past experience shows that the economy could be well into recovery before a tax cut would have its major impact on demand.

Fundamental tax reform would be better considered in a less political climate after the election and when the economy is no longer in recession. We still like best those tax changes that would encourage savings and investment. But if we are going to have a tax cut this spring aimed at middle-income taxpayers, let's at least get the incentive structure right. It's hard to think of an option that would be better than asking Congress to bring back the deduction for second earners.

Martin Feldstein, the former chairman of the Council of Economic Advisers, and his wife Kathleen, who is also an economist, write frequently together on economics.

PREPARED STATEMENT OF GEORGE N. HATSOPOULOS

It is becoming increasingly evident that Japanese corporations are developing new businesses and are penetrating new markets at a much higher rate than do their U.S. industry counterparts. Many of the businesses that Japan has come to dominate over the past 20 years, from robots to VCRs, were based on inventions and technology developed in America. The same is true for many additional technology-based businesses the Japanese are vigorously pursuing at this time such as high definition television and supercomputers.

This disparity in corporate behavior in the two countries is attributed by many analysts to an observed preoccupation of U.S. business leaders with short-term earnings as contrasted to a long-term vision. Such a short-term orientation of corporate managers may be explained in two ways: First, it may mean that most corporate managers are incompetent; or alternatively it may mean that there are disparate incentives and constraints that drive the behavior of these two sets of managers.

Having studied the problem for several years, I have concluded that the second explanation is central to our dilemma. In most cases that I have reviewed, the cause of the so called business myopia can be traced to wrong incentives and constraints imposed on American managers by both the macroeconomic environment and the financial structure of the ownership of our corporations.

The aggressive pursuit of market penetration, whether it is accomplished through superior technology or lower prices is a very costly proposition. For example, the assets that Japanese automakers deployed in the United States to capture the U.S. market produced losses that were sustained for more than one decade. Such an aggressive behavior has been and continues to be practiced by virtually every Japanese manufacturing industry in their pursuit of either existing or future markets. As a result, returns on corporate assets are consistently much lower in Japan than in the United States.

During the five years, 1985 through 1989, the inflation adjusted pretax operating income of all nonfinancial U.S. corporations was 11.1 percent of the replacement value of net operating assets but only 6.2 percent in Japan.[1] A similar difference was exhibited in prior years. Even if we assume that the competence of both labor and management is the same in the two countries, it is not hard to see why U.S. industry has been losing ground. In order to achieve higher returns than their Japanese competitors, U.S. corporations have had to bias the deployment of their assets primarily towards businesses that are currently profitable; hence, they must accept a loss in their market share. Such a conclusion does not prove that management and labor in the United States is as competent as that in Japan, it just points out that other things being equal, the pursuit of high returns necessitates short-sightedness and eventual loss of market share.[2]

REQUIRED RATES OF RETURN AND THE COST OF CAPITAL

A primary issue for policymakers concerned with U.S. industrial competitiveness is the question of what drives corporations to pursue high rates of returns. One obvious reason is that corporate managers must earn enough to cover their cost of capital, for if they fail to do so over a sustained period of time, their capital base will decline.

The pretax cost of capital for a corporation is defined as the pretax return a corporation must earn on its assets to cover taxes, interest payments, and the return required by its equity investors. Calculation of the cost of corporate capital in any specific country is a complex process involving many assumptions. As a result, the estimates reported by various investigators differ substantially one from another. There is, however, a simple way to estimate the cost of capital without reverting to intricate calculations.

A corporation is always obliged to pay its taxes and make its interest payments. Therefore, the only latitude it has, if it cannot cover its cost of capital, is to shortchange its equity holders. If equity holders feel shortchanged, their only recourse is to sell their stock. It follows, therefore, that a convincing indication of a company's ability to cover its cost of capital is that it issues more new equity than it retires. Conversely, if a corporation retires more equity than it issues, it means that it expects to be unable to earn enough to cover its cost of capital.

During the five-year period, 1985 through 1989, U.S. nonfinancial corporations retired $500 billion more of their equity than they issued. This amount was 13 percent of the average market value of their stock. Since their average return on net assets employed over these five years was 11.1 percent, it follows that their cost of capital was than 11.1 percent. In contrast to their U.S. counterparts, over the same five years, Japanese nonfinancial corporation issued more new equity than they retired

by an amount equal to 7 percent of the average market value of their stock. This implies that their cost of capital was *less* than the 6.2 percent they earned.

We may conclude, therefore, that during the period in question the cost of capital in the United States was, on average, more than 80 percent higher than that in Japan.

CAUSES OF THE HIGH U.S. COST OF CAPITAL

My recent studies of the cost of capital in the United States and Japan indicate that in recent years the cost of capital advantage of Japan derives solely from their much lower cost of equity.[3] The current situation is quite different from what it was prior to 1983 when the Japanese cost of capital advantage derived from lower real interest rates and higher leverage i.e., higher debt-to-equity ratios in Japan. The elimination of barriers to capital flows across countries during the 1980s has caused real interest rates in the two countries to converge. Moreover, a decline in the cost of equity in Japan has caused Japanese firms to reduce their leverage.

In addition to changes in the components of the cost of capital, the character of the competition between the two countries has also changed over the past decade. During the 1970s the focus of competition was toward basic industries. During the 1980s, the focus has shifted towards high technology industries. Unlike basic industries the primary investments required for high technology are in risky intangibles such as research and development. Such speculative investments cannot be financed with debt—they can only be supported with equity. Thus, an advantage in the cost of equity is becoming more important than an advantage in the cost of debt.

The previous comparison of the United States with Japan applies at least qualitatively to the U.S.-Germany competition. Capital cost in general and equity cost in particular are much lower in Germany than in the United States although not as low as they are in Japan.

Equity financing in each country is provided mainly by each nation's pool of savings. For that reason, the low saving rate in the United States is a principal cause of its high equity costs. The net U.S. saving rate in the 1980s was 4 percent of national income—a sharp contrast to 12 percent in Germany and 20 percent in Japan.

The low saving rate in America, however, is not the only cause for high equity costs. National saving provides funds to both equity-financed and debt-financed investments. In the United States, the returns from debt-financed projects are taxed less than those from equity-financed projects. The opposite is true in Germany and Japan.

The high taxation of corporate equity investments in the United States derives from the double taxation of dividends and from the double taxation of retained earnings. Double taxation of dividends is readily apparent: Earnings are taxed at the corporate level and then again at the investor level when paid as dividends. Double taxation of retained earnings, however, is a more abstract concept. It comes about because, on average, corporate shares appreciate directly in proportion to after-tax retained earning. When an investor buys a corporate share and then sells it later at a higher price, the tax is levied at the capital gains rate—even though the appreciation may be the sole result of the accumulation of after-tax profits.

In Germany, capital gains from equity investments are excluded from taxation at the investor level. The same was true in Japan prior to 1989; since 1989, capital gains from equity investments have been taxed at a small rate that decreases for longer-term investments. In both of these countries, the double taxation of retained earnings is virtually eliminated. Dividends, on the other hand, are given only minor relief from double taxation. This has led corporations in Germany and especially in Japan to retain most of their earnings and to pay only small dividends. These policies cause national saving in our two major competitor nations to be funneled mostly into corporate equities.

In addition to saving rates and tax policy, there is another very important factor that affects the cost of equity capital: The corporate ownership structure. The owners of U.S. corporation are primarily institutional agents and individuals, most of whom have a small stakes in large numbers of companies. They monitor and evaluate corporate shares through publicly available information and superficial research focused primarily on forecasting events. As a result, they have insufficient information to assess long-term values. They influence corporate management in three ways: Proxy voting, trading of shares, and corporate takeovers.

In contrast to the United States, the corporate owners in both Japan and Germany are primarily corporations and institutional owners most of whom have large stakes in a few companies. They monitor and evaluate corporate share through inside information and fundamental research focused primarily on long-term values. They influence corporate management through active board membership, direct con-

tact with management, and strong informal networks. The result of the Japanese and German ownership structure is a better assessment of intrinsic values and a lowering of investment risk.[4]

TAX POLICY RECOMMENDATIONS

The most important tax policy issues facing the United States are: First, the reduction and eventual elimination of the bias in the tax code that favors consumption over investment and, second, the reduction and eventual elimination of the double taxation of retained earnings.

For the United States to remain a major economic power, our national saving rate must be restored to at least the pre-1980 historical level of 10 percent of national income. To accomplish such a goal, we must eliminate the federal deficit without the use of social security surpluses and to cause private saving to increase. These objectives can only be attained through a shift from the direct taxation of incomes towards the direct taxation of consumption.

Eliminating the double taxation of retained earnings, under a least-cost-to-the-Treasury criteria, can be achieved by effectively integrating corporate and personal taxation. Under this plan, capital gains would continue to be taxed at the same rate as other income, but a tax credit would be provided against capital gains taxes equal to the taxes paid at the corporate level. The following example serves to illustrate how the proposal would work.

Let someone buy a corporate share for $100 and sell it five years later for $200. The capital gain would be $100, and the tax liability at 30 percent would be $30. Let the corporate earnings per share over the five year period be $50 after corporate tax payments of $20. The individual would be given a tax credit of $20, and the tax liability would be reduced from $30 to a mere $10.

The proposed tax credit should be limited to an escalating fraction of the corporate taxes paid after enactment, depending on the length of time corporate shares are held by the investors after enactment. For example, this fraction would be 10 percent after three years with a 10 percent increment for each additional year up to 10 years.

I believe that the tax credit I propose should be fully funded through some additional tax imposed on short-term traders of corporate equities, not only for fairness reasons but also in an attempt to modify the behavior of corporate stockholders.

ENDNOTES

1. The returns cited are adjusted for accounting differences between the United States and Japan. The raw data for Japan were obtained from the Economic Planning Agency and Daiwa securities and for the United States from the Federal Reserve System and Compustat data base. The analysis is described in "Rates of Return on Japanese and U.S. Nonfinancial Corporations: New Evidence on International Cost of Capital Differences," by George N. Hatsopoulos and James M. Poterba, presented at the third annual Harvard-Stanford Workshop on Economic Policy, U.S. and Japan: Financial Systems, Corporate Governance, and Cost of Capital, November 8, 1991.

2. My company, Thermo Electron, has similar plants in the United States Germany, and Japan. Our own experience indicates that our U.S. workforce is better than that in either Germany or Japan.

3. See: "Technology and the Cost of Equity Capital," by George N. Hatsopoulos, from the Symposium on Technology and Economics, National Academy of Engineering, April 5, 1990.

Also: "Cost of Capital: Reflections of a CEO," by George N. Hatsopoulos, Business Economics, Volume XXVI, Number 2, April 1991.

4. See: "Investment Behavior and Time Horizon in American Industry," by Michael E. Porter, Harvard Business School, 1992 (to be published).

PREPARED STATEMENT OF EDWARD R. MCCRACKEN

Mr. Chairman and members of this Committee, I am Edward R. McCracken, president and Chief Executive Officer of Silicon Graphics, Inc. I'm pleased to be here today before you to present my views on how structural changes in the U.S. tax code could increase the competitiveness of U.S. business. But first, I would like to spend a few minutes giving you some background about my company, Silicon Graphics, so that you have an understanding of my perspective.

Our Company was founded in 1982 by Dr. James Clark, a computer science professor at Stanford University, and six of his graduate students. We design, manufac-

ture and sell state-of-the-art computers for use by technical professionals in design, engineering, animation, simulation and scientific analysis. Our particular expertise is in the area of high-performance computer graphics which provide realistic, three dimensional images to the user. Silicon Graphics is the undisputed leader in our field. To give you a sense of our size, in 1984 our revenues were $5 million; just seven years later, in 1991, we reported revenues of $550 million. That is a compounded annual growth rate of almost 96%.

Our systems are used by NASA and the commercial aerospace industry for aircraft design and simulation and by the defense industry to train pilots and to build better airplanes, tanks and submarines. By the military for simulation and mission planning during Desert Storm. By automobile companies to design and to test innovative ideas—to build safer cars. By the environmental, medical and physical science communities to calculate and visualize CFC's effect on our environment and to design new drugs. By the broadcasting and movie industries who used our technology to create special effects in movies like *Terminator 2* and *Beauty and the Beast* and by the U.S. Olympic Bobsled team to simulate the bobsled run they will compete on at Albertville, France next week. And by many many others whose tasks or efforts are aided by precision design and analysis. Our technology, which we call "visual computing," provides our customers a competitive advantage in the analysis of their particular problem or task and in the design and production of their solution. We are a technology leader, a significant employer and taxpayer and we are a living example of the benefits of government support for business.

The creation of Silicon Graphics was facilitated by a Government program which was designed to stimulate research and entrepreneurial risk taking. Dr. Clark's original work, which formed the basis for our Company, was done under the auspices of a Defense Advanced Research Project Agency, or "DARPA," grant. This grant provided $5 million over the course of 4 years to the Stanford Electronics Laboratories at Stanford University. Stanford University encouraged Dr. Clark to start the Company and in fact, issued the Company the rights to patented technology developed under the program. With the technology and a business plan, Dr. Clark was able to attract over $30 million of venture capital between 1982 and 1985, when capital gains enjoyed the benefit of lower tax rates. Thus the Company, its employees, investors and customers are all beneficiaries of government policy supporting research, risk-taking and investment.

The ripple effect that the founding of this one company has had on our economy is extremely positive.

We directly provide jobs in the U.S. for 2,200 people in 33 states and an additional 550 people in 25 countries. A portion of our business is generated by hundreds of resellers and software developers, who in turn employee thousands of workers. And we create more jobs indirectly at our suppliers, sub-contractors and customers. Over a period of ten years we have created an enterprise that has a market value today of $1.25 billion.

At Silicon Graphics every employee is granted a stock option because we believe that sharing in the ownership of the Company is critical to its ultimate success. Stock options allow a company like ours to attract and retain the best and the brightest people. This creates wealth in the economy, savings for further investment and tax income for the government.

Our revenues are divided 50% domestically and 50% internationally. We have a positive balance of trade with both Japan and Europe. In calendar year 1991 sales in Japan accounted for $90 million in revenue, while we purchased $60 million in components from them; thus a net of $30 million to the Company and the economy. In Europe we sold approximately $185 million and purchased $10 million in materials for a net positive of $175 million.

In our fiscal 1991 year we paid $2 million in income taxes to the federal government alone and over the ten years since the Company was created we've paid $15 million in total. In addition the Company pays state and local taxes in 40 different jurisdictions. It is obvious that the potential leverage of government support in tax revenue alone can be used to justify the investment. The other economic benefits to the country and, more specifically the communities in which we work, multiply this many times over.

And Silicon Graphics is just one company. One example of how well-conceived, focused policy can be a boon to the American economy. There is the opportunity to recreate Silicon Graphics thousands of times over and tax policy can be a major part of that effort.

What I have covered so far is by way of background to the real question you want me to address. "What is important to American technology companies in terms of our ability to continue to compete successfully on a world wide basis?" Silicon Graphics' past successes have been significant, but our future success and the suc-

cess of others like us is directly related to our ability to stay at the forefront of the technological revolution. Let me address three areas in which I believe a change in the long-term tax policy of this country could have strikingly positive effects.

Stimulate Research. First, the heart beat of any leading-edge technology company is research and development. At Silicon Graphics, we spend about 12 cents out of each dollar of sales to fund our R&D efforts. Aggressive spending allows us to stay competitive. The tax savings directly attributable to the research and experimentation tax credit has been used to finance additional research and development projects. As a Company we have reinvested $4.6 million of credits since our inception in 1982.

It is my understanding that since enacted in 1981, the credit has been extended and/or changed five times. And every time Congress deliberates on the future of the credit, those of us in technology development hold our breaths. And in the meanwhile, we evaluate and plan our research programs in two ways—with and without the credit. This lack of stability seriously impedes our ability to effectively plan research activities. Furthermore, I believe the above pattern of changing and extending the credit substantially decreases the credit's incentive effect.

A permanent extension of the R&D credit is vital to America's competitive position. As you are aware, high technology industries in particular are subject to ferocious competition both domestically and abroad. The relative tax incentives provided by various locales have to be considered in deciding if and where a company will conduct its research activities. By permanently lowering the cost of initiating research in the U.S., making the R&D credit permanent will provide not only the incentive to conduct such research within the U.S., but the incentive to conduct such risky ventures altogether.

I cannot emphasize enough the role that research and development plays in the U.S. economy. New products mean new jobs and thus, renewed growth. We need to stimulate investment in research and development and this mechanism is effective and simple to implement.

Stimulate use of technology. In order for U.S. corporations to either become competitive, or to continue their competitive advantage, it is critical that U.S. workers have access to state-of-the-art development and manufacturing technology. That is, tools which will allow them to be a more productive economic force. So, it is imperative that the Government provide incentives for U.S. business to invest in new capital equipment—both hard assets and technology. Accordingly I urge you to reinstate a permanent investment tax credit for purchases of new capital equipment. Similar to the R&D credit, an investment tax credit will provide corporations with additional funds to invest in research and development, additional production equipment, and other growth producing assets or services. As with the R&D credit, such an incentive must be of a permanent nature. Long-term capital formation and international competitiveness is not encouraged by means of short-term tax incentives such as the proposed investment tax allowance. Short-term tax incentives create additional complexity within the tax law and temporarily skew the economic results of our tax policy. Short-term incentives, in other words, are short-sighted. We need to support the upgrading of our national capital base through permanent capital investment incentives.

Capital Gains. The 1986 Tax Reform Act has had an negative effect on young, emerging, high growth companies. It has penalized long-term investors by increasing the long-term capital gains rate, while at the same time has provided incentive to short-term "gamblers" by cutting their tax rate. This approach has signaled corporations and individuals alike that long-term investments are at least unnecessary, if not foolhardy. The short term investment focus created by this environment puts young, high growth companies at a disadvantage as they struggle to raise new capital. Many opportunities have been and will be lost as good ideas wither from lack of capital with a long term focus. With them go the jobs, the tax revenues and the technology leadership that we all know this country needs. Silicon Graphics and companies like us must have access to capital markets to fund growth. A reduction in capital gains would promote long-term investing.

Every other industrialized nation either exempts capital gains from tax, taxes such gains at reduced rates, or at least adjusts assets' bases for inflation. This distinction between the U.S. capital gains taxation and the international community's capital gains treatment puts U.S. industry at a distinct disadvantage. U.S. and foreign investors alike place their funds where they will receive the best return for the risk. Clearly the tax rate on capital gains can heavily influence this decision.

For 65 years the tax laws provided a tax rate differential for long-term capital gains. Since the elimination of this differential, capital formation has suffered as a result of which the annual number of venture-backed startup companies has declined. These losses to our economy are irrecoupable. We should not make the same

mistake for our future. Reduce the capital gains tax rate, and tie the reduction to new long-term capital aimed at investing in growth and innovation. Failure to do so will penalize the long-term risktaking essential to long-term economic success. We must reward the long-term investor, even if it is at the expense of the short-term investor.

In summary, I believe you have the opportunity to help American business compete and succeed in an increasingly competitive world. And the payoff for taking these actions will be felt throughout the economy, from the paycheck created far an individual employee to the tax revenues generated for the U.S. government. And the actions are simple and straightforward. You need to set in place, permanent tax policies which: (1) provide companies with an incentive to aggressively deploy resources in research and development, (2) encourage corporate purchases in state-of-the-art product development and manufacturing technology which ultimately provides competitive advantage, and (3) encourage a long-term mentality amongst investors and thereby create an on-going source of capital for new companies and new ideas.

Thank you for this opportunity to state my views to you today.

PREPARED STATEMENT OF JOHN B. SHOVEN

I. INTRODUCTION

Before I begin, let me congratulate the Subcommittee for holding hearings on long run tax policy issues at a time when there is a great deal of concentration on short-run fixes for the recessionary economy this election year. For the most part, I will refrain from discussing anti-recession policies except where I see opportunities to improve long run economic performance simultaneously.

I am going to concentrate on policies to encourage economic growth and productivity. The fact that there is something wrong with the long run performance of our economy is most vividly demonstrated by noting that the purchasing power of the average blue-collar weekly paycheck is no greater today than it was in the late 1950s. Basically, in these regards, I feel that we have three major problems in this economy, all of which are related to tax policy. They are:

1. Inadequate National Saving.
2. Inadequate National Investment.
3. Excess Reliance on Debt Financing.

I will discuss these three concerns in turn, describing the tax policies which need to be adopted to make progress on these fundamental problems.

II. INADEQUATE NATIONAL SAVING

We all know in our personal lives that we can't get wealthier without setting aside some money as saving. That is equally true at the national level. The U.S. net national saving rate is pathetic, averaging 2.0 percent of GNP in the last half of the 1980s. All components of saving: personal saving, business saving, and government saving declined dramatically from the 1950–1980 period when U.S. saving ranged from 7 to 8 percent of GNP. The tax implications of inadequate saving are:

1. We need to improve the deficit and balance the federal budget within the next four years. This will require tight controls on spending and tax increases. What could be done right now to stimulate the economy and improve the long run saving in the economy would be to enact strong measures which assure that we are on a path towards eliminating the chronic federal government deficit. What should be enacted are tax increases that would take effect some 18 months hence. Such moves would signal to Wall Street and to the average American that the fiscal situation is being addressed and the specter of high inflation is really dead. It is likely, depending on the design of the future tax increases, that they would stimulate the economy in the short run as people and firms try to beat the tax increase.

2. We must encourage private saving rather than discourage it. We need to set a goal for the country in terms of saving (a reasonable goal would be to return to a national saving rate of approximately 7.5 percent) and then take actions to achieve that goal. The first thing to know about private saving is that pension accumulations account for a staggering fraction of all saving. It is not too much of an exaggeration to say that pensions are how Americans save (over and above the accumulation of home equity and Social Security entitlement). In the 1980s, the Flow-of Funds National Balance Sheet figures of the Federal Reserve System show that the increase in real pension assets exceeded the increase in the real wealth of the

country. With this in mind, it seems misguided to curtail the tax incentives for pensions in order to improve the federal budget. Effectively, such actions tax private saving in order to improve public saving. Last week's Bush Administration proposal to strip away the tax benefits from most annuities sold to individuals is equally counterproductive. The main reason that it is important to improve the deficit is to increase national saving. However, not all ways of balancing the budget will stimulate national saving equally. If our goal is to increase national saving, as I think it should be, then the obvious tax source for improving the budget deficit is some form of consumption based tax. I personally would favor substantially higher federal gasoline or energy taxes; they are both an effective environmental policy and a potentially large revenue source.

3. Saving incentives such as individual retirement accounts have the potential to increase private saving. They would be even more effective if their design were changed so that all saving in excess of some floor amounts were tax advantaged rather than only saving under a fixed ceiling amount. That is, I think replacing the ceilings with floors would make a lot of sense. We want to encourage people to save large amounts and not simply to transfer limited amounts into tax sheltered vehicles. The floors could be designed in a way to achieve the desired equity between the treatment of people with different incomes. For example, one could stipulate that all of the saving of households with income under $40,000 would be tax deductible, whereas people with incomes between $40,000 and $100,000 would only get to deduct their saving in excess of three percent of income, and, finally, people with incomes above $100,000 would only be allowed to deduct saving in excess of five percent of income. This idea of unlimited IRA accounts with graduated floors was first proposed by James Tobin of Yale and recently advocated by B. Douglas Bernheim of Princeton.

III. INADEQUATE INVESTMENT

The rate of net national investment was also lower in the 1980s than in the previous three decades, falling from an average of nine percent of GNP to slightly less than seven percent. Despite being twice as large an economy as Japan, total investment in Japan has exceeded total investment in the United States for the past couple of years. Weak investment translates to slow productivity growth, which results in the poor performance of wages in the economy. Investments in corporations is discouraged by the fact that the returns on such investments face two levels of taxation, one at the corporate level and the second at the personal level. In contrast, the return on owner-occupied homes is almost completely untaxed. Most economists believe this distorts the allocation of capital in the economy towards housing capital and away from the corporate capital which is most effective in raising wage rates. I should also add that most analyses of the distribution of tax payments across income classes ignore the two levels of taxation on corporate capital and fail to allocate the burden of corporate taxation to people. The exception to this remark was the research of the late Joseph Pechman, who found that the progressivity of the income tax depended crucially on the incidence of the corporation income tax.

Just like the case of national saving, increasing national investment will require increased public and private investment. Government investment would include additional support for education as well as additional funding of important infrastructure investments (such as improving roads, bridges, sanitation facilities, etc.). Private investment can best be stimulated by lowering the effective price of private investment, which is termed by economists "the cost of capital" and by businesspeople the "hurdle rate." The cost of capital could be lowered by several alternative policies. They include:

1. Allowing expensing of capital costs instead of depreciation.
2. Reinstituting the investment tax credit for equipment.
3. Indexing depreciation deductions for inflation.
4. Lowering the tax rate on capital gains.
5. Integrating the personal and corporate income tax systems.

The first three of these lower the cost of capital by making the deductibility of capital costs more adequate. The first two could effectively neutralize the impact of the corporate tax on the cost of capital. The cost of capital could be reduced by as much as one-third. The Bush Administration proposal for a 15 percent Investment Tax Allowance (which really involves a simple acceleration of depreciation deductions for equipment bought before January 1, 1993 and installed before July 1, 1993) would have a small, temporary effect of lowering the cost of capital. An investment tax credit can be a powerful tool to stimulate investment demand in times of

recession. This ability argues against its use as a permanent, long run solution to the inadequacy of investment.

The capital gains tax stimulates investment through a different mechanism. Lower anticipated capital gains taxes would cause the stock market to rise. Once this rise had occurred (and it should take place very quickly, perhaps even anticipating the change in the tax law), the rates of return offered by the stock market would be lower. With lower returns on equity investments, people should be more willing to make real investments with the retained earnings of firms. The point is that the stockholders are making an investment when the firm commits to a new capital project. The return which is demanded of this endeavor must be competitive with the terms offered by outside financial investments. All that said, decreased capital gains taxes tend to lower the cost of capital less than an investment tax credit. The question is how much higher the stock market would be with the Administration's capital gains proposal than without it—my guess is it might be four percent higher (130 points on the Dow Jones average). If that is right, the lower tax rates on capital gains would lower the cost of capital by roughly four percent. This lowering would benefit all investment (not just equipment investment as with the ITC). Growing firms which retain all or almost all of their earnings would enjoy a larger fall in their cost of capital. How efficient a capital gains tax is in lowering the cost of capital gets us back to the endless debate about the revenue consequences of reducing capital gains taxes. As you know, there is room for disagreement about these predictions. My guess is that lowering capital gains taxes does reduce the present value of Treasury tax receipts, albeit by a modest amount. I favor lower capital gains taxes, achieved perhaps by indexing the calculation of gains for inflation. I should also note that the United States has one of the highest rates of tax on capital gains in the world. However, my real long run preference would be for a more comprehensive capital tax reform as described below.

IV. EXCESS RELIANCE ON DEBT

All that was said above about the double taxation of corporate capital was really only accurate for equity capital. If firms finance their investments with debt and offer the returns to the financiers in the form of interest, there is only one level of taxation at most. The return to debt is deductible from the corporation income tax base, whereas dividends and the return to equity are not. This definitely provides a bias in favor of debt, a fact that was taken advantage of in a big way in the 1980s. The bias towards debt makes our corporations unnecessarily vulnerable to recessions in terms of the probability of financial distress and bankruptcy. What is needed, in my opinion, is a tax on corporate cash flow which is neutral with respect to dividends and interest payments.

V. A BOLD, LONG-RUN AND COMPREHENSIVE PLAN TO IMPROVE SAVING, INVESTMENT, AND FINANCIAL NEUTRALITY

Having just criticized the Treasury proposal to tax the returns on annuities, let my turn around and praise the Treasury for its Report on Integration of the Individual and Corporate Tax Systems released last month. This report details several alternative long run proposals to remove the double taxation of corporate capital returns. Again, we are one of the few major economies which does not have some form of integration of corporate and personal taxes. Some of the Treasury prototype plans are quite bold and appear to be worthy of serious implementation studies. The prototype proposal that I find most appealing is what the Treasury refers to as the Comprehensive Business Income Tax (CBIT). The CBIT would equate the treatment of debt and equity, would tax corporate and noncorporate business alike, and would greatly reduce the difference in the tax treatment of dividends and retained earnings. Briefly, under the CBIT there would be no tax on capital income at the level of the equity or debt holder. However, corporations would pay a tax as they do now except that interest would no longer by deductible. The full return to debt holders and equity holders would be taxed at the corporate level. The tax rate of the corporation income tax could be set to be equal to the maximum rate of the personal income tax (currently 31 percent). The Treasury Report states that there would be no revenue loss if we moved to a CBIT with a 31 percent corporate rate. The loss in revenue from not taxing equity and debt returns at the investor level would be completely offset by the revenue gained by the disallowance of the interest deduction at the corporate level. There would be no obvious rationale to retain a capital gains tax on corporate securities. The Treasury Report suggests a ten year phase in for such a radical reform.

My opinion is that we should be looking at desirable tax policy over at least a ten year horizon. The Comprehensive Business Income Tax prototype developed by

the Treasury has a great deal of appeal. All business capital, whether corporate or noncorporate, debt or equity financed, would face the maximum personal income tax rate, collected at the business level. No one can argue that this offers the affluent an enormous tax break. After all, all capital income would pay the maximum personal rate. What the prototype does offer are (1) higher rewards for savers, (2) a lower cost of capital and hence more investment, (3) less reliance on debt as the tax break enjoyed by debt relative to equity is removed, and (4) simplicity as all taxes on business income would be paid at the business level—all this, and it doesn't lose revenue relative to the current tax system. So, my conclusion is that this Subcommittee and the country should be studying the Treasury's long run integration report with the same intensity that we are considering the Administration's growth package, many of whose elements are designed to be effective over the short run.

COMMUNICATIONS

STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

The American Insurance Association (AIA) is a national trade association headquartered in Washington, D.C., representing 240 major companies which provide all lines of property and casualty (P&C) insurance in all 50 states and throughout the world. Included among AIA's members are U.S. insurers with a longstanding commitment to doing business abroad through foreign insurance subsidiaries.

The AIA acknowledges that taxation is only one of many factors which affect international competitiveness. However, the AIA believes that U.S. tax law has a significant impact on the competitiveness of U.S. based multinational insurance organizations. In particular, we are concerned that the changes enacted as part of the Tax Reform Act of 1986 (1986 Act) have placed U.S. owned insurance companies at a competitive disadvantage in foreign markets.

Prior to the 1986 Act, U.S. controlled foreign corporations (CFC's) engaged in the insurance business were generally subject to the same scheme of U.S. taxation as applied to other industries engaged in an active trade or business. Earnings of foreign subsidiaries were deferred from current U.S. taxation.[1] As was, and continues to be, the general case for non-financial businesses, earnings were not subject to U.S. taxation until repatriated. This principle of deferral allowed U.S. multinational insurers to compete in local foreign markets on an equal footing with other country multinationals and local competitors with respect to tax costs.

The 1986 Act represents a major departure from established U.S. tax policy when it comes to taxation of U.S. controlled foreign insurance companies. Responding to a concern regarding potential tax haven activities, the 1986 Act eliminated deferral for income of insurance CFC's, both underwriting and investment income, except for a limited category referred to as same country risk underwriting income.[2]

These changes were adopted without any hearings or opportunity for industry input. The limited explanation provided in the legislative history suggests to us that these sweeping changes were an overreaction to, and misunderstanding of, a fairly narrow tax avoidance possibility. The House Ways and Means Committee Report (Committee Report) assumes that certain "movable income" earned through a foreign insurance corporation could be earned through a domestic corporation and that the major motivation of moving income offshore is tax benefit. Although the focus of the Committee Report seems to be tax havens, the resulting statutory changes and administrative interpretations are not directed to tax haven activities, but rather encompass all insurance activities outside the United States.[3]

It is simply not true that a domestic corporation can engage in insurance business outside the U.S., i.e. issue insurance contracts that cover property and liability risks located in foreign countries, without establishing a place of business in a foreign jurisdiction. Generally a company needs to obtain a license and comply with local country regulation to write insurance in foreign jurisdictions. While it may be the case that in some jurisdictions a U.S. company would have the choice of doing business through a branch or a local subsidiary, this choice is not always available. In addition, doing business through a foreign subsidiary is frequently more efficient from a capital utilization standpoint. For example, within the member states of the

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[1] Prior to the 1986 Act, income related to insurance of U.S. risks was currently taxable as subpart F income.

[2] Under Code section 953, taxable insurance income is income attributable to the issuance of an insurance or annuity contract covering risks arising outside the country of incorporation of the controlled foreign corporation. Pre-1986 Code exceptions from current taxation, under section 954, for investment income related to necessary reserves and surplus were repealed by the 1986 Act.

[3] See, H.R. Rep. No. 99–426, 99th Cong., 1st Sess. 391, 392, 393 (1985).

European Economic Community (EEC), less capital is required to be maintained locally if a business is conducted through a company incorporated in a member state. Further, where a company incorporated in one EEC member state engages in business through other member states, less capital is required if a branch of an EEC company is used rather than forming a separate subsidiary for each EEC member country. The 1986 Act provisions, which tax any income related to cross border risks as Subpart F income, impose current U.S. tax on income earned through such an EEC insurance company.

The Committee Report presumes that all cross border insurance is tax motivated based on the incorrect assumption that income can be routed through a corporation formed in any convenient jurisdiction. From this wrong assumption the Report then concludes that when a CFC insures risks outside its country of incorporation, it is appropriate to treat the income as if it had been routed through that jurisdiction primarily for tax reasons.[4]

This rationale would lead one to conclude that a U.S. controlled Belgium insurance company which writes property and liability insurance on French, German, Italian or other EEC member company risks and is subject to regulation and taxation in each of these countries, is engaged in a U.S. tax avoidance activity—a conclusion which is plainly wrong. Rather, this structure is used because it is less costly and is the most efficient use of capital.

It is our understanding that the United States is the only country to impose immediate taxation on insurance income earned outside its borders through home country controlled foreign subsidiaries. Given that insurance products sold in foreign markets are dictated by local market conditions and regulation, U.S. owned companies must offer the same sort of products as their foreign competitors. U.S. tax burdens which increase costs above that of the competition will make it difficult if not impossible for U.S. owned companies to compete. We do not believe that subpart F was intended to prevent U.S. owned multinational organizations from competing effectively with either non-U.S. owned multinational organizations or local foreign companies in foreign markets. However, the 1986 changes to subpart F are producing this adverse competitive effect.

We appreciate that in lowering regular corporate tax rates, the 1986 Tax Act was generally favorable to corporations. However, in the case of property and casualty insurance companies, this rate reduction was more than offset by other tax law changes. Discounting of loss reserves and a 20% reduction in the deduction for unearned premium reserves results in a much higher tax base than existed prior to the 1986 Act.[5] These changes accelerated the timing of recognition of income for U.S. property and casualty insurance companies. Since most foreign jurisdictions do not require discounting of loss reserves, effective tax rates on property and casualty insurance companies are generally higher in the United States than most other jurisdictions. As a result, the high tax exception proves to be of limited use to U.S. controlled foreign insurance corporations even though foreign statutory rates are frequently higher than the U.S. statutory rate.[6] A high tax exception which was based on foreign statutory rates or which looked to foreign tax accounting rules with respect to items which affect the timing of recognition of income would be more appropriate for insurance CFC's.[7]

One other change wrought by the 1986 Act deserves further comment. The 1986 Act currently taxes under subpart F all investment income of an insurance CFC on the incorrect assumption that investment activity is not part of the insurance business. The Committee Report suggests that investment income is inherently manipulable regardless of the nature of the business earning such income, the implication being that investment income can be routed through selected foreign countries to produce tax benefits. This is simply not the case for insurance CFC's. Insurance CFC's, just like domestic insurance companies, are required to maintain minimum capital as well as reserves for incurred losses and unearned premiums as a condition of doing business in a given jurisdiction. To the extent that there is a concern about sheltering passive investment income from current U.S. tax, this concern

[4] H.R. Rep. No. 99-426 at 395.

[5] *See, Report to the Congress on Property and Casualty Insurance Company Taxation*, Department of the Treasury, April 1991, which concludes that the 1986 changes in the taxation of property and casualty insurance companies increased regular tax liabilities for calendar year 1987 by approximately $1.5 billion

[6] Section 954(b)(4) provides an exception to subpart F for income subject to an effective rate of income tax in the foreign country greater than 90 percent of the maximum U.S. statutory rate.

[7] *See. e.g.*, H.R. 2320 introduced by Mr. Guarini on May 14, 1991 which would amend the high tax exception to permit the use of foreign accounting rules where the foreign statutory rate is greater than 90 percent of the U.S. rate.

should be more properly directed towards investment income generated from assets in excess of minimum required capital and reserves. Certainly this should be the case for investment income related to same country risks. Even the 1986 Act excluded same country underwriting income from current taxation; investment income necessary to support same country underwriting should likewise be excluded. We believe that investment income related to cross border risks also should be excluded from subpart F for the reasons expressed above regarding cross border insurance activity generally.

There is another consequence of U.S. tax law which impacts international competitiveness. U.S. tax laws, in particular the changes enacted in 1986, subject U.S. companies to an unparalleled level of complexity and compliance costs. The arbitrary distinctions between same country and non-same country risks, underwriting and investment income coupled with requirements for discounting of loss reserves by line of business and accident year, require CFC's to gather data and create extensive books and records solely for U.S. tax purposes. This, in and of itself, increases the costs of doing business relative to non-U.S. owned companies. In some instances, CFC's may be required to request information from their customers which is not obtained in the ordinary course of business and is not required by foreign competitors. This will have the effect of discouraging foreign insureds from doing business with U.S. owned foreign insurance companies.[8]

We would like to make one final observation regarding the seemingly contradictory trade and tax policies of the United States. While our trade negotiators have been at least partially successful in eliminating barriers against the admission of U.S. owned insurance carriers to participate in foreign markets, our tax laws have created new barriers which tend to make meaningless the hard-won concessions wrested from our trading partners. Yet, foreign countries have enacted none of our restrictive tax laws, so that our foreign competitors can take full advantage of their unrestricted access to the U.S. market.

RECOMMENDATIONS

U.S. tax policy with respect to U.S. owned foreign insurance enterprises should be re-examined. At a time when U.S. trade policy is seeking to lower barriers to entry in foreign insurance markets, U.S. tax policy should not be discouraging expansion into foreign markets by imposing greater tax burdens on U.S. owned multinational insurers than our trading partners impose on their multinationals with respect to business done outside their borders.

Deferral for most unrepatriated earnings of foreign insurance subsidiaries should be restored. Tax avoidance concerns should be addressed by statutory provisions targeted at potential abuses rather than by broad provisions which sweep in legitimate active business income along with income that properly may be considered tainted from a tax policy standpoint.

[8] The proposed regulations under Code section 953 issued on April 17, 1991 are replete with complex formulas and requirements for collection and creation of books and records which while arguably within the scope of the statute, will be impossible for taxpayers to comply with or the IRS to administer. See, Prop. Treas. Reg. §§1.953-1 *et seq.*

STATEMENT OF THE CHEMICAL MANUFACTURERS ASSOCIATION

INTRODUCTION

My name is Allen J. Lenz. I am Director for Trade and Economics of the Chemical Manufacturers Association (CMA). CMA appreciates the opportunity to testify on U.S. international competitiveness, a matter of extreme importance to the nation's future.

CMA is a non-profit trade association whose member companies represent 90 percent of the productive capacity for basic industrial chemicals in the United States. The U.S. chemical industry is a vital component of the U.S. economy. It employs 1.1 million workers and produces about 1.9 percent of GNP, about one-twelfth of the contribution of U.S. manufacturing. U.S. chemicals is a high-technology, R&D oriented, capital intensive industry that is very competitive in international markets. In 1990 chemical industry exports were $39 billion, equal to the nation's total agricultural exports, and significantly larger than U.S. aircraft exports of $30.1 billion.

Throughout the 1980s, when most other U.S. industries were incurring large trade deficits, the chemical industry maintained trade surpluses, although in 1985 the industry's surplus did decline to only $7.1 billion. In 1990 the U.S. chemical industry earned a trade surplus of $16.5 billion. In addition, however, the industry's earnings from its investments abroad--the profits from the operations of its foreign affiliates, the licensing of its technology to those affiliates, and other charges levied on foreign affiliates--were $2.7 billion larger than the comparable earnings of foreign chemical companies in the United States. Thus, the total positive contribution of the chemical industry to U.S. international transactions in 1990 was $19.2 billion, a very strong performance in the face of a $99.3 billion U.S. current account deficit--the sum of all U.S. international transactions.

Notwithstanding this excellent record, CMA believes the industry's contributions could have been still greater. Moreover, despite the current strong performance in international markets, CMA is very much concerned about the chemical industry's future and, more broadly, about the future of manufacturing in the United States. CMA believes that there cannot be a strong, highly competitive U.S. economy in the decades ahead without a strong, highly competitive, world-class U.S. manufacturing industry leading the way. CMA also is of the opinion that current trends and policies will not lead to a world-class U.S. manufacturing sector, and that major changes in attitudes and policies will be required to enhance and maintain the competitive position of U.S. manufacturing in a highly competitive world economy.

There is a mutual dependence between the chemical industry and the rest of U.S. manufacturing. About half the output of the U.S. chemical industry goes to other U.S. manufacturing industries as inputs to their production processes. Chemicals is such a keystone industry--its products are so vital to other manufacturing industries--that we cannot long have a strong, competitive U.S. manufacturing industry without a top-notch chemical industry. But neither can we expect to have a strong, world-class, internationally competitive U.S. chemical industry without a U.S. manufacturing industry that is itself strongly competitive. Chemicals needs a thriving U.S. manufacturing sector, partly because other manufacturing industries are its main customers. Large U.S. manufactures trade deficits represent lost opportunities for the U.S. chemical industry because imported goods contain chemical processing done in the exporting country, not in the United States.

But the mutual dependence between the chemical industry and the rest of U.S. manufacturing goes beyond pure customer-supplier relationships to factors that include the cross-flow and exchange among industries of new product and process technologies, exchanges that are critical to improvements in U.S. competitiveness. It will be extremely difficult for chemicals--or any other major U.S. manufacturing industry--to remain at the forefront of international competition if most of the rest of U.S. manufacturing is lagging in world competition.

For these reasons, this statement focuses not specifically on the chemical industry's immediate problems but on the U.S. manufacturing sector as an entity--on manufacturing's role in U.S. competitiveness, and on its performance, prospects, and problems in an increasingly more integrated and competitive world economy.

In this statement I will show the following:

o The manufacturing sector is the key to U.S. international competitiveness--the primary interface of the U.S. economy with the world economy, the sector most exposed to foreign competition.

o The United States has not been faring well in the competition among nations for world manufactures markets. Performance has improved since 1987, but the improvement has been inadequate and the outlook for further significant gains is dim.

o U.S. government policies have played an important role in the decline of U.S. manufacturing's international competitiveness.

o Government policies should also play an important long-term role in the revitalization and improved competitiveness of U.S. manufacturing.

MANUFACTURING-THE KEY TO INTERNATIONAL COMPETITIVENESS

Manufactures trade has been and will continue to be the critical determinant of U.S. trade and current account performance. From 1981 to 1987 the balance on U.S. international transactions--the U.S. current account--declined from a $7 billion surplus to a $162 billion deficit, a $169 billion slide. During the same period, the manufactures trade balance moved from a $22 billion surplus to a $125 billion deficit, a $147 billion downturn, equivalent to 85 percent of the current account decline. Similarly, $52 billion of the $63 billion 1987-90 improvement in the current account balance--83 percent of the total--was in manufactures trade. Moreover, a detailed examination of the components of the current account shows that manufactures trade must also provide the great majority of improvements that may occur in the foreseeable future.

The dominant role of manufactures in U.S. trade is not unique among industrialized countries. Manufactures trade is by far the largest component of world goods and services trade, about 57 percent of the 1989 total according to GATT data.[1] Manufactures trade is also the fastest growing, most volatile component of world trade, with flows sometimes switching among countries quite rapidly. It is the "swing factor" in world trade flow patterns, the primary means by which net international resource transfers among nations are accomplished.

The dominant role of manufactures in world trade among industrialized countries and its volatile nature make manufactures trade the primary means through which national economies compete with one another in the world economy. In fact, commercial competition among industrialized and industrializing nations is primarily a struggle among them for manufactures markets.

In a world where most goods are readily tradeable and most services are not, manufacturing is the primary interface of the U.S. economy with the world economy--the sector most exposed to foreign competition. This interface of the U.S. manufacturing sector with the world economy is more than a dull, abstract concept but is a fact of life that has profound policy making implications. For industrialized countries, large net capital outflows--net foreign lendings--are typically manifested in large manufactures trade surpluses. Large net capital inflows--net borrowings--translate to large manufactures deficits.

The immediate effects on the manufacturing sector of policies that alter net international capital flows are amplified compared to their effects on sectors more insulated from foreign competition. Indeed, because manufacturing is the sector most exposed to foreign competition, some policies may affect manufacturing very differently than they affect other sectors. These effects, examined later in this statement, indicate the need for a consistent, specific focus on the effects of national economic policies on the international competitiveness of U.S. manufacturing.

U.S.MANUFACTURING'S INTERNATIONAL COMPETITIVENESS

In the ten years from 1981 through 1990 U.S. current account deficits totalled $807 billion. Manufactures deficits during the period were $668 billion, 83 percent of the total. The largest deficit was in 1987, $125 billion, equivalent to about 2.8 percent of GNP that year (figure 1). Since 1987, performance has improved. The 1990 manufactures trade deficit was $73 billion, an amount equivalent to about 1.3 percent of U.S. GNP.

But although manufactures trade performance has improved significantly, by no means is U.S.-based production of manufactured goods yet sufficiently competitive in international markets. Using 1990 as a reference point, an additional improvement of about $100 billion in the manufactures trade balance would be needed to eliminate U.S. current account deficits by 1993 (figure 2). This would result in a manufactures trade surplus of about $25 billion. The $100 billion improvement in manufactures trade needed to avoid continued large U.S. current account deficits and

external borrowing--an amount equivalent to about 1.8 percent of 1990 GNP--is clear evidence that U.S.-based manufactures production is not yet sufficiently competitive.

Nor do market share data indicate a restoration of U.S. manufacturing's international competitiveness. The United States in 1981 was the world's largest manufactures exporter and had a 15.8 percent share of world manufactures exports (figure 3 and table 1). By 1987, however, the share had dipped to 11.6 percent before recovering in 1989 to 13.0 percent, still substantially below the 1981 share. U.S. import shares moved in the opposite direction during the period. In 1981 the United States had a 15.0 percent share of world manufactures imports. That share rose to 23.0 percent in 1985, indicating that the United States that year was taking almost one-fourth of world manufactures exports. After declining to 18.1 percent in 1989, the import percentage was still 3.1 percent above 1981 levels.

Thus, by the straightforward tests of trade balances and market shares, U.S. manufacturing has not yet regained the needed degree of required international competitiveness in world markets. But what about the future? Do existing trends indicate continuing improvement toward a world-class U.S. manufacturing sector that can generate the surpluses needed to eliminate U.S. current account deficits and external borrowing?

THE OUTLOOK FOR MANUFACTURES TRADE PERFORMANCE

From recent media accounts, one might conclude that U.S. manufacturing's problems are almost over. Some examples:
A February, 1991 New York Times front page story headlined "American Revival in Manufacturing Seen In U.S. Report" was an optimistic account of the progress of U.S. manufacturing, indicating "growing consensus among many economists that the long-term problem in the nation's economy is not dilapidated, inefficient factories but productivity growth among the white-collar service sector."[2]

A March Wall Street Journal story headlined "U.S. Manufacturers Poised for Rebound: Slimmed-Down Sector Awaits End of Recession" noted that a growing number of economists think that "U.S. manufacturing [is] ready to lift off when the economy snaps back."[3]

In April another New York Times front page story headlined "Boom in Manufactured Exports Provides Hope for U.S. Economy" related that "the lower dollar has done wonders for American industry" and that "in a quiet revolution, the United States, long derided as an industrial has-been, has become one of the world's low-cost manufacturers. . ".[4]

And a May front page Washington Post story was headlined "U.S. Firms Stage Competitive Revival." The story indicated that "American manufacturers--written off by many commentators in the 1970s and '80s as dinosaurs doomed to succumb to Japanese and other foreign rivals--have staged a remarkable comeback, reviving American competitiveness in many industries."[5]

These stories correctly relate the greatly improved performance of U.S. manufacturing. Things are, indeed, much better than they were in 1987. I believe, however, that these accounts--which are essentially compilations of anecdotal evidence--probably leave readers with expectations of continued improvement in manufacturing's performance that are unduly optimistic.

My own research indicates much deeper and longer term problems for U.S. manufacturing. Assuming a recovery of the U.S. economy, related increases in U.S. demand for imports, and no further major depreciation of the dollar, we should expect only modest further gains in the manufactures trade balance over the next few years. In research over the last two years I have examined in detail the trade performance and prospects of 21 different product groups constituting over 90 percent of U.S. manufactures trade. The results of this research will be published this fall by the Institute for International Economics in a book to be titled "Trimming the U.S. Current Account Deficit: A Sectoral Assessment." Based on this product-by-product analysis, my projection is that the manufactures trade balance is unlikely to improve by more than $10 to $20 billion by 1993, only a small fraction of the $100 billion gain I estimate would be needed to eliminate the current account deficit by that date.

The following are a only few of the more detailed findings of my research that lead to the general conclusion of only marginal improvement in manufactures trade by 1993:

o The road vehicle (autos, trucks, parts) deficit, down to $43 billion in 1990, will likely expand again by 1993, to about $50 billion.

o Aircraft, the largest single trade surplus category, $24 billion in 1990, may expand its surplus by another $3 to $4 billion by 1993, but larger gains are unlikely.

o Modest declines in the chemicals trade balance, a $16.5 billion surplus in 1990, are likely by 1993 as new capacity being built by industrializing countries comes on stream.

o Deficits will continue to expand in several product groups where U.S.-based production fills only a small part of total U.S. consumption. These include: footwear, 1990 deficit, $9.1 billion; clothing, a $23.1 billion 1990 deficit; and miscellaneous manufactures, a $6.9 billion deficit.

o Latin America was a key U.S. export market at the beginning of the decade. But lagging economic performance has held down the ability of most Latin countries to import and the prospects for strong economic progress in the region are not bright.

o U.S. performance has often been best in specialized, high technology products such as Aircraft and precision instruments that, unfortunately, have relatively small world markets. World exports of aircraft in 1989 were $53 billion; scientific equipment exports were $45 billion. In contrast, world exports of road vehicles (autos and trucks), a category in which U.S. performance has lagged, were $263 billion. A product-by-product assessment shows no prospective "big winners" that can add large gains to U.S. trade balances.

o Enhanced market competitiveness of U.S.-based production in world markets--U.S. and foreign--depends fundamentally on improved price competitiveness, including quality and product performance considerations. Productivity gains--a key source of competitiveness improvements--have been inadequate to score major advances on key foreign competitors.

o There is little evidence that U.S. price competitiveness will continue to improve without further depreciation of the dollar. Neither reported recent U.S. manufacturing productivity gains nor recent U.S. spending for capital investment and research and development in the manufacturing sector give reason to expect that productivity gains in the years just ahead will provide the basis for marked improvements in the market competitiveness of U.S. manufactures.

o There was not during the 1980s an "investment boom" in U.S. manufacturing. There was not a rate of plant and equipment modernization likely to provide sustained improvement in the international market competitiveness of U.S. manufacturing relative to its foreign competitors. The "investment boom" was, instead, in other sectors, including some--retail and financial services, shopping malls, office buildings, etc.--where overbuilding is now a key factor in the problems of the savings and loan and insurance industries. From 1981 to 1989 the manufacturing sector's net capital stock rose 0.8 percent, retail trade's by 5.2 percent, and services' by 6.2 percent.[6]

THE ROLE OF U.S. ECONOMIC POLICIES

Policy makers have for many years been talking about an increasingly interdependent and more competitive world economy. But unfortunately, talking about these changes and designing and implementing policies that react effectively to them are different things. An integrated and much more competitive world economy is now a reality. But U.S. policy making that integrates domestic and international factors and considers the U.S. need to compete in the world economy is not. Much of the cost of failure to adjust U.S. policies to new global realities has fallen on manufacturing because it is the sector most exposed to foreign competition.

The effects on the manufacturing sector of lack of appropriate responses to a changing world are readily illustrated by events. During the 1980s a combination of U.S. government policies triggered large net inflows of foreign capital that helped to create a period of prosperity and over investment and over development in some other sectors but seriously damaged the manufacturing sector, shrinking it and impairing its long-term international competitiveness.

But even before the beginning of the 1980s the competitive position of U.S. manufacturing had been declining, partly as a result of U.S. government policies that did not respond to a changing world. And, even today, in the 1990s, there has not been appropriate policy recognition of the critical role and vulnerability of U.S.-based manufacturing, nor of the cumulative impact of earlier policies on its international competitiveness. Too often, economic policy decisions--fiscal,

monetary, tax, regulatory, and other policy decisions--are made as if the United States were still dominant in world trade and need not be concerned about international competition.

HOW TO IMPROVE U.S. MANUFACTURING'S INTERNATIONAL COMPETITIVENESS

Unfortunately there is no simple solution to U.S. manufacturing's competitiveness problems--no single policy quick fix, no "silver bullet." U.S. competitiveness did not decline as a result of a single event or policy, but as a result of the accumulation of policies and events. Turning the tide will, therefore, require consistent attention in a wide spectrum of policy areas. Indeed, successfully competing in an ever more integrated and competitive world economy--balancing U.S. external accounts without the prop of a continually depreciating U.S. dollar--will require policy makers to focus consistently on the effects of the whole spectrum of U.S. economic policies on the international competitiveness of U.S. business and industry.

But because manufactures trade is the key to U.S. trade performance, there should be consistent, specific consideration of the effects of U.S. economic policies not just on U.S. business but, more specifically, on the ability of U.S.-based manufacturing production to compete in U.S. and foreign markets. There are also other powerful reasons to move U.S. manufacturing from the periphery of economic policy making concerns to a more center stage position. Rebuilding and maintaining a strong, world-class U.S. manufacturing sector would have benefits well beyond eliminating large U.S. trade and current account deficits.

The idea that the United States is becoming more and more a services oriented economy has been oversold and misinterpreted. Manufacturing is reckoned, on a National Income and Product Accounts basis, to originate about 23 percent of U.S. GNP (constant 1982 dollars).[7] But 23 percent of GNP is simply the value added by the manufacturing sector itself. Manufacturing is both a producer and a consumer. It draws on the products of mines, farms, forests, and many other industries for the raw materials, transportation, power, and myriad other services necessary to produce manufactured goods. Manufacturing, for example, takes two-thirds of the output of U.S. mining, almost a fourth of the output of the business services and power utilities sectors, and more than a fifth of the nation's transportation and warehousing services. All told, the inputs of other industries into the production of manufactured goods and manufacturing's own value added sum to about 35 percent of U.S. GNP. That is, more than one-third the total output of the U.S. economy and about two-fifths of the private sector portion of the economy is directed toward the creation of manufactured goods. This does not include the services involved in the wholesaling, retailing, after-production servicing, and use and disposition of manufactures after they are produced. In other words, the U.S. economy still very much functions around goods production. Other sectors each are still relatively small compared to the resources directed to goods production.

The strong, world-class manufacturing sector essential to U.S. international economic leadership will require high levels of investment in U.S.-based research and development and in U.S.-based production facilities, levels of investment that have not been occurring. Many other nations, however, have recognized the key role of manufacturing in world competition and are pursuing policies that encourage investment in the manufacturing sector. Indeed, there is now an ongoing international competition for investment in manufacturing--a competition for the plants that bring with them jobs, new technologies, and value added benefits for local and national economies.

Individual state governments have been important players in the international competition for manufacturing investment, establishing overseas offices to solicit investments in their states, and often negotiating concessions with potential investors, most of them foreign. In contrast, the U.S. government has too often taken an adversarial view of U.S. business and has given little attention to the international competitiveness needs of U.S.-based manufacturing. This contrasts with the way many foreign governments view their manufacturing sectors. Other, more trade-oriented industrialized countries have long been more affected by their interaction with the the world economy than has the United States. They typically consider carefully the trade and competitiveness effects of their domestic and international economic policies. As a result of these contrasting approaches, the United States is lagging key foreign rivals in the competition for investment in manufacturing. It can compete successfully with other countries for needed manufacturing investment only if it provides a more attractive, more hospitable environment for manufacturing.

CMA does not suggest any subsidies or special programs to attract investment to particular manufacturing industries or, indeed, any such programs aimed specifically at manufacturing. Instead, U.S. policy makers can best begin to improve the environment for investment in U.S.-based manufacturing by consistently giving careful consideration to the effects of the full spectrum of U.S. economic policies--fiscal, monetary, tax, regulatory, environmental, social services, et.al.--on the international competitiveness of the U.S. goods production sector. A first step is to recognize that every action that reduces the attractiveness of manufacturing investment in the United States has its cost in terms of manufacturing's long-term international competitiveness. The effects of individual actions may appear to be small, but cumulatively can be very important.

OBJECTIVES OF A POLICY MAKING FOCUS ON MANUFACTURING

A policy making focus on the international competitiveness of U.S. manufacturing should have the following objectives:

o reduce and eliminate the need for the net capital inflows--the net external borrowing--that ensures current account and manufactures trade deficits. This must be done, however, in ways that will not discourage new investment in U.S.-based production and in the quality jobs it produces.

o avoid in the future policies that cause large net capital inflows.

o give specific consideration to the effects of new legislative and regulatory proposals on U.S.-based manufacturing's international competitiveness.

o reexamine the effects of current tax, regulatory, and other policies on investment in U.S. manufacturing and its international competitiveness.

Reducing and Eliminating the Need for External Borrowing

Because net capital inflows from foreign sources translate to manufactures trade deficits, narrowing and ultimately eliminating the current large net inflows is of crucial importance to manufacturing's long-term outlook. The shortest, surest way to eliminate the need for net capital inflows is to cut and eliminate the federal government budget deficit. This is the most logical and important single step to be taken. It is critically important, however, that government budget deficits be eliminated in ways that will not discourage the increased investment in manufacturing R&D and plant and equipment that is vital to increased productivity and competitiveness of U.S. manufacturing. For example, most forms of increased corporate taxes might help, at least in the short term, to cut the government budget deficit. But such tax increases would also increase the cost of U.S.-based production compared to foreign production, and in turn, decrease investment in U.S.-based manufacturing and its competitiveness.

Avoiding sudden, large net capital movements International trade is a means of exchanging goods and services to the benefit of the parties involved. It is also is the means by which net international capital transfers are accomplished. But because these capital movements are manifested primarily in manufactured goods, major shifts in net international capital flows can significantly affect and disrupt the manufacturing sectors and the structural composition of the economies involved.

For example, policies that trigger large net capital inflows may appear in the short term to be "good" for the receiving economy as a whole, allowing rapid growth in aggregate consumption and investment. For example, most sectors may do well in an environment of net capital inflows. During the 1980s, U.S. construction, retail and wholesale trade, and financial services industries generally did very well.

At the same time, however, policies that cause large net capital inflows may have very unfavorable effects on the recipient country's manufacturing sector, depressing output and investment in manufacturing and shrinking it while expanding other sectors. This is, in effect, what happened during the 1980s when policies facilitated large net capital inflows to the United States that resulted in a period of sustained growth for most elements of the U.S. economy. But although other sectors prospered and expanded, manufacturing was hard hit by an overly strong dollar that depressed exports, boosted imports, and displaced U.S.-based production. Investment was diverted from manufacturing to other sectors. Now, however, if the current account is to be balanced and foreign borrowing eliminated, the manufacturing sector will have to expand again relative to U.S. consumption of manufactures while some other overbuilt sectors will be contracting. The economic and social costs of alternating expansions and contractions of manufacturing and other sectors are high.

They include the over expansion and subsequent contraction of some elements of the economy that have brought us the savings and loan crisis and the problems of the insurance industry. Costly, unnecessary fluctuations of this kind should be avoided in the future.

Investors have not forgotten the overly strong dollar of the 1980s. Sustained high levels of investment in U.S. manufacturing will be more likely if investors feel assured that the overly strong dollar and large net capital inflows that began in the 1980s are eliminated and will not recur. The first task of policy makers is to eliminate the current net inflows. Then policies that prevent a recurrence should be followed.

Examining New Legislative and Regulatory Initiatives In an integrated world economy, the effects of national economic polices on the competitiveness of U.S.-based production go beyond those caused by U.S. budget deficits and sudden, large changes in net international capital flows. Manufacturing's competitiveness is affected by the cumulative impact of a very wide spectrum of government actions. A growing stream of government policies, laws, rules, and regulations impose costs on all U.S. businesses. A continuing series of actions that impose new costs on manufacturing can raise the costs of U.S.-based production above those of foreign competitors, lowering its competitiveness and discouraging new investment in it. Ignoring these effects and, in effect, relying on dollar depreciation and other slow to come, delayed adjustments to restore investment in U.S. manufacturing will inevitably put U.S.-based production in a catch-up, follower position, making it more and more dependent on foreign technology and foreign investment.

Some regulatory actions may impose obvious huge costs on U.S. manufacturing. The recent Clean Air Act amendments provide an example, adding an estimated $25 billion annually to U.S. industry's costs.[8] The immediate impact on costs and competitiveness of many individual laws, rules, and regulatory actions may, however, be small and less obvious. But together, the cumulative effect of many seemingly small government actions on the international competitiveness of U.S.-based production is very important. Not including the costs of the Clean Air Act amendments and other new controls that may be legislated, environmental protection costs are expected to grow to about 2.8 percent of GNP by the year 2000.[9] About half that will likely fall on U.S. manufacturing.

Moreover, the effects of government actions on a manufacturing sector exposed to international competition may be quite different than the effects on other sectors that are more insulated from foreign competition. For example, direct, explicit taxes levied on firms raise their operating costs. So do indirect taxes--perhaps in the form of environmental regulatory actions or mandated programs with social objectives. In the end, these cost increases must be passed on in price increases or borne by the affected businesses in ways that affect their profits and capital formation--in the case of manufacturing, the investments in the R & D and plant and equipment necessary to remain competitive.

A cost increase passed on by a firm not exposed to foreign competition affects it negatively but not as immediately and directly as a cost passed on by a manufacturing firm that is exposed to foreign competition. For example, the costs of compliance with environmental requirements incurred by dry cleaning establishments are clearly not good for dry cleaning businesses. To some extent, the resulting price increase may reduce the nation's consumption of that service and may shift resources out of dry cleaning services and into other sectors. But the cost of environmental compliance will not disadvantage domestic producers of dry cleaning services relative to foreign competitors because it is normally impractical to import dry cleaning services.

The potential effects of cost increases imposed on a manufacturing firm exposed to foreign competition, however, can be quite different. If the costs of environmental regulations for U.S.-based production are greater than those of foreign-based production, U.S.-based production is disadvantaged, imports increase, exports decrease, jobs are lost, and investment in U.S.-based production decreases, at least until a new cost equilibrium is restored by dollar depreciation, which in turn puts downward pressure on living standards.

In addition to the visible effects of job losses in the manufacturing sector, until dollar depreciation or other adjustments restore a competitive balance vis-a-vis foreign producers, one effect of cost increases imposed by government actions is to make investment in U.S.-based manufacturing and R & D less attractive relative to investment in other U.S. industries more insulated from foreign competition. Another is to make investment in U.S.-based manufacturing less attractive relative to investment in foreign-based production.

Plant shut-downs, production cutbacks, and job losses are more tangible and dramatic than investment declines but there are important long-term costs in actions that even temporarily shrink investment in manufacturing. Exchange rate movements and other adjustments internal to the economy will theoretically ultimately restore investment in manufacturing to a level that avoids unsustainably large manufacturing deficits and very large declines in the competitiveness of U.S.-based production. But the adjustments may be a long time in coming, and in the meantime, the delays may add immediately and importantly to the actual costs of adjustment. For example, while adjustment is occurring, competitors with higher levels of profits and R & D and investment in plant and equipment may strengthen their hold on U.S. and foreign markets and may achieve technological breakthroughs and productivity gains that will be increasingly difficult and costly to match. Indeed, while awaiting dollar exchange rate decline or other adjustments to offset increased U.S. costs, manufacturing skills may be eroded and whole industries may disappear, further raising the difficulty and cost of restoring competitiveness, whether by investment-triggered productivity gains or by dollar depreciation.

Some individual government actions may result in immediate, visible, production cuts and job losses but most will not. Instead the effects will be longer term, less visible, but insidious with very important cumulative effects. In making assessments of the effects of policy initiatives on the international competitiveness of U.S. manufacturing, policy makers therefore need to consider not just the incremental costs of individual initiatives, but the cumulative effects of prior actions and a continuing flow of new initiatives.

Reexamination of Existing Policies Both investment in U.S. manufacturing and the competitiveness of U.S.-based production have been lagging in a U.S. economic environment set by a complex network of governmental laws, rules, and regulations Particularly important to investment decisions are the laws and regulations that determine the initial incidence--the initial burden--of taxation. Like other governmental actions that raise costs and prices, the initial incidence of taxes has a more direct and more immediate effect on manufacturing firms exposed to foreign competition than it does on firms less exposed to foreign competition.

Although tax policy--the kinds, levels, and initial incidences of taxes levied in executing a given fiscal policy--has very important effects on investments, there has been little attention to its effects on U.S. international competitiveness. Populist views of tax policy typically favor heavy taxation of business. "Fairness and equity" are rallying cries for laying taxes on large corporations seen as having "deep pockets." Corporations are, however, inanimate and do not bear the burdens of corporate taxes, which are simply passed on to consumers, employees, and stockholders (including employee pension funds that hold large blocks of corporate stocks). But taxes levied on corporations also lower their profits, reduce rates of return on investment, raise the cost of capital, and lower spending on research and development and capital investment, with ensuing effects on U.S. international competitiveness.

There is a fundamental conflict between populist views of tax policy and the international competitiveness of U.S. manufacturing. It simply is not possible to have a competitive, world-class manufacturing sector without it being a profitable sector that will attract high levels of investment in R & D and plant and equipment. To the extent that U.S. tax policy bears more heavily on U.S.-based production than do foreign tax policies on foreign-based production, U.S. based-production is disadvantaged and investment in foreign-based production is encouraged until compensating exchange rate and other adjustments occur. Investment in service industries and other industries wherein foreign-based production for U.S. markets is not an alternative is not affected by U.S. tax policy in the same way. Service industries may be disadvantaged or damaged by bad tax policies, but they will not be displaced by foreign production.

Specific tax policy recommendations are beyond the scope of this statement. However, if the United States is to regain and maintain a strong international competitiveness position, a reexamination of U.S. tax policies and their effects on capital formation and international competitiveness is essential. The candidates clearly include: the alternative minimum tax, investment and research and experimentation incentives, allocation of expenses of U.S. manufacturing operations to foreign source income, the potential substitution of a value-added tax for other taxes that undermine U.S. competitiveness, and the use of tax policy in easing the added costs of new environmental requirements on manufacturing's international competitiveness.

MANUFACTURING'S FUTURE IN THE UNITED STATES

The future of U.S. manufacturing will be shaped in no small measure by federal and state government policies. But the outcomes from different policies will not necessarily be immediately apparent, sharply etched in black and white contrasts. Manufacturing will not disappear from U.S. shores whether or not the United States adopts policies designed to compete with other countries for investment in manufacturing. In fact, a very large U.S. manufacturing sector will continue in a discouraging, even abusive, environment for investment in manufacturing R & D and plant and equipment. The kind of manufacturing sector that survives and the contribution it makes to the U.S. economy will, however, be very much determined by the environment for investment in manufacturing which, in turn, is very much set by federal and state government policies.

A large U.S. manufacturing sector will survive under almost any circumstances simply because goods production is such a large portion of the whole U.S. economy that net manufactures imports--a manufactures trade deficit--can at most be only a small portion of total consumption of manufactured goods. The United States cannot import a very large portion of its total consumption of manufactures and pay its way in the world economy. A large, but lagging, inept, low-productivity manufacturing sector, short on innovations and new products and processes, would be kept viable and unsustainably large manufactures trade deficits would be precluded by compensating adjustments in U.S. and foreign economies. U.S. adjustments would include the substitution of labor for capital, declining manufacturing relative wages, lower U.S. economic growth that would hold down U.S. demand for manufactures, and a consistently depreciating dollar. Another result would be a manufacturing sector increasingly foreign-owned and employing more and more foreign technology. In short, manufacturing would survive an unfavorable environment in the United States, but it would lag behind other nations that choose to provide a more favorable environment and would not make a full contribution to the growth of U.S. living standards.

A dynamic, world-class, U.S. manufacturing sector, on the other hand, will not be assured solely by U.S. policies that create a more favorable environment for investment in U.S.-based research and development and U.S.-based production. Many factors will decide the outcome of the competition among industrialized and industrializing nations for manufacturing leadership. But one can know that federal and state government policies will do much to shape the outcome, and that the wrong policies can assure the continued decline of U.S. manufacturing and the attendant increasing costs to the U.S. economy as a whole. Moreover, even though there will be a lag of several years between the enactment of policies more favorable to U.S. manufacturing and improved U.S. competitiveness, there are few, if any, other areas where significant pay-offs can be achieved more quickly. For example, improvements in U.S. education implemented now will require nearly a generation to have significant effects.

Notes:

1. General Agreement on Tariffs and Trade, International Trade 1989-90, Vol. I, Geneva, 1990, p. 5.

2. Sylvia Nasar, "American Revival in Manufacturing Seen In U.S. Report", New York Times, Feb 5, 1991, p. A-1.

3. Thomas F. Boyle, "U.S. Manufacturers Poised for Rebound", Wall St. Journal, March 22, 1991, p. A-2.

4. Sylvia Nasar, "Boom in Manufactured Exports Provides Hope for U.S. Economy", New York Times, April 21, 1991, p. 1.

5. Evelyn Richards, "U.S. Firms Stage Competitive Revival", Washington Post, May 20, 1991, p. 1.

6. Stephen S. Roach, "On the Road to Restructuring", Paper prepared for a symposium sponsored by the American Council on Capital Formation, Washington, D.C., November 8, 1990.

7. U.S. Department of Commerce: Survey of Current Business, April, 1991, p. 27.

8. U.S. Department of Commerce, U.S. Industrial Outlook, 1991, p. 12-4.

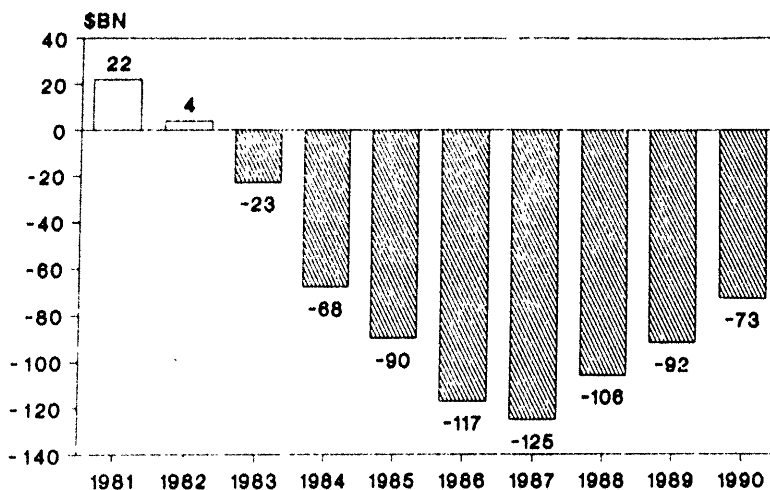
9. U.S Environmental Protection Agency, Environmental Investments: The Cost of a Clean Environment, A Summary, December, 1990, p. 2-1.

Table 1
World Manufactures Trade by Country Shares

Country Shares	1981	1982	1983	1984	1985	1986	1987	1988	1989	Change 1981-89
Share of Exports to World										
United States	15.8%	15.0%	14.1%	14.2%	13.8%	11.6%	11.6%	12.1%	13.0%	-2.8%
Canada	3.8%	3.9%	4.4%	4.9%	4.8%	4.2%	3.7%	3.6%	3.5%	-0.3%
Japan	14.6%	13.9%	14.6%	15.6%	15.3%	15.1%	13.7%	13.2%	12.8%	-1.8%
EC	46.9%	47.6%	46.3%	43.6%	44.2%	46.8%	47.3%	44.3%	44.4%	-2.5%
To External	23.6%	23.5%	22.7%	21.7%	21.7%	21.5%	20.7%	19.1%	18.8%	-4.8%
Germany	15.2%	16.0%	15.3%	14.3%	14.7%	16.3%	16.4%	15.0%	14.8%	-0.4%
France	7.5%	7.2%	7.0%	6.6%	6.6%	6.8%	6.8%	6.4%	6.4%	-1.1%
Italy	6.3%	6.4%	6.4%	6.0%	6.0%	6.4%	6.3%	5 8%	6.0%	-0.3%
U.K.	6.9%	7.0%	6.4%	6.1%	6.2%	6.1%	6.3%	6.1%	6.1%	-0 8%
Other Western Europe	8.2%	8.2%	8.2%	7.7%	8.3%	8.8%	8.9%	8 5%	8.0%	-0.2%
NICs	4.2%	4.9%	5.5%	6.3%	6.0%	6.3%	7.1%	8 9%	8 5%	4.3%
EE - U.S.S.R.	1.1%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.1%	1.0%	-0.1%
Developing Countries	5.1%	5.0%	5.6%	6.2%	6.2%	6.0%	6.4%	7.3%	7.6%	2 5%
Latin America	1.6%	1.7%	2.0%	2 3%	2.3%	2.0%	2.1%	2.4%	2.4%	0.8%
Rest of World	0.2%	0 3%	0.2%	0 2%	0 2%	0.2%	0.3%	1.0%	1.0%	0.8%
Share of Imports from World										
United States	15.0%	15.5%	17.7%	21.9%	23.0%	21.6%	20.0%	18.5%	18.1%	3.1%
Canada	4.8%	4.2%	4.9%	5.6%	5.5%	4.9%	4.4%	4.6%	4.5%	-0.3%
Japan	3.0%	3.0%	3.2%	3.5%	3.2%	3.2%	3.7%	4.3%	4.7%	1.7%
EC	36.6%	36.8%	36.6%	34.3%	34.6%	38.3%	40.7%	39.7%	40.3%	3.7%
From External	13.9%	13 6%	13.8%	13.2%	13.1%	14.1%	15.0%	15.3%	15.5%	1.7%
Germany	9.0%	8.9%	9.2%	8.5%	8.4%	9.5%	9.9%	9.3%	9.4%	0.4%
France	6.5%	6.7%	6.3%	5.7%	5.7%	6.5%	6.9%	6.7%	6.7%	0.2%
Italy	3.8%	3.8%	3.6%	3.7%	3.8%	4.2%	4.6%	4.5%	4 6%	0.8%
U.K.	6.4%	6.7%	7.0%	6.6%	6.6%	6.7%	7.1%	7 5%	7.3%	0.9%
Other Western Europe	8.1%	8.0%	7.9%	7 4%	8.1%	9.0%	9.3%	8.7%	8.3%	0.2%
NICs	3.8%	4.2%	4.5%	4.7%	4.1%	4.5%	5.0%	7.1%	7.6%	3.8%
EE - U.S.S.R.	2.5%	2.6%	2.6%	2.1%	2.1%	2.1%	1.9%	1.9%	1.7%	-0.8%
Developing Countries	24.1%	23.1%	20.4%	18.2%	17.1%	14.7%	13.1%	12 8%	12.4%	-11 7%
Latin America	6.6%	5.5%	4.0%	4.2%	4 1%	3.8%	3.5%	3.4%	3.4%	-3 2%
Rest of World	0.7%	1 0%	0.9%	0.8%	0.7%	0.6%	0.7%	1 3%	1 0%	0 3%
Export Share Minus Import Share										
United States	0.8%	-0.5%	-3.6%	-7 7%	-9 2%	-10.0%	-8.4%	-6 4%	-5.1%	-5 9%
Canada	-1 0%	-0.3%	-0.5%	-0 7%	-0.7%	-0.7%	-0.7%	-1 0%	-1.0%	0.0%
Japan	11.6%	10.9%	11.4%	12.1%	12.1%	11.9%	10.0%	8 9%	8 1%	-3 5%
EC	10.3%	10.8%	9.7%	9.3%	9.6%	8.5%	6.6%	4.6%	4 1%	-6 2%
External	9.8%	9.9%	9.0%	8.5%	8.6%	7.4%	5.7%	3 8%	3.3%	-6.5%
Germany	6.2%	7.1%	6.1%	5.8%	6.3%	6.8%	6 5%	5.7%	5.4%	-0 8%
France	1.0%	0.5%	0.7%	0.9%	0.9%	0 3%	-0.1%	-0.3%	-0.3%	-1 3%
Italy	2.5%	2.6%	2.8%	2.3%	2.2%	2 2%	1.7%	1.3%	1.4%	-1.1%
U.K.	0.5%	0.3%	-0.6%	-0.5%	-0.4%	-0.6%	-0.8%	-1.4%	-1.2%	-1.7%
Other Western Europe	0.1%	0.2%	0.3%	0 4%	0.2%	-0.2%	-0.4%	-0.2%	-0.3%	-0 4%
NICs	0.4%	0.7%	1.0%	1.6%	1.9%	1.8%	2.1%	1.8%	0 9%	0 5%
EE - U.S.S.R.	-1.4%	-1.6%	-1.6%	-1.1%	-1.1%	-1.0%	-0.8%	-0.8%	-0 8%	0.6%
Developing Countries	-19.0%	-18 1%	-14.8%	-12.0%	-10.9%	8.7%	-6.7%	-5.5%	-4.8%	14.2%
Latin America	-4 9%	-3.8%	-2.0%	-1.8%	-1.8%	-1.8%	-1.4%	-1.0%	-0.9%	4 0%
Rest of World	-0 5%	-0.7%	-0.7%	-0.6%	-0.6%	-0.4%	-0 5%	-0.3%	-0.0%	0 5%

Source: OECD Trade Statistics, SITC Rev. 2.
From. "Trimming the U S. Current Account Deficit: A Sectoral Analysis"
Forthcoming from Institute for International Economics, Fall 1991

Figure 1
U.S. Manufactures Trade Balance
1981-90



Source: U.S. Department of Commerce

Figure 2
Estimated Manufactures Trade Performance
Improvement Required to Balance
U.S. Current Account by 1993
($ Billions)

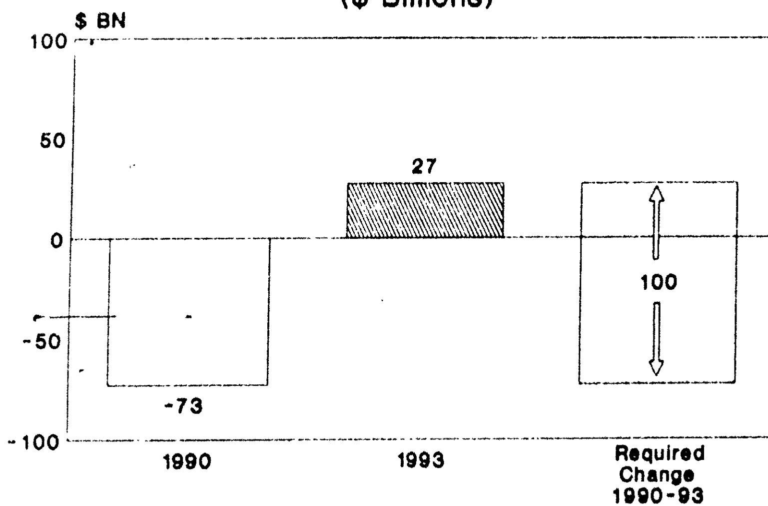
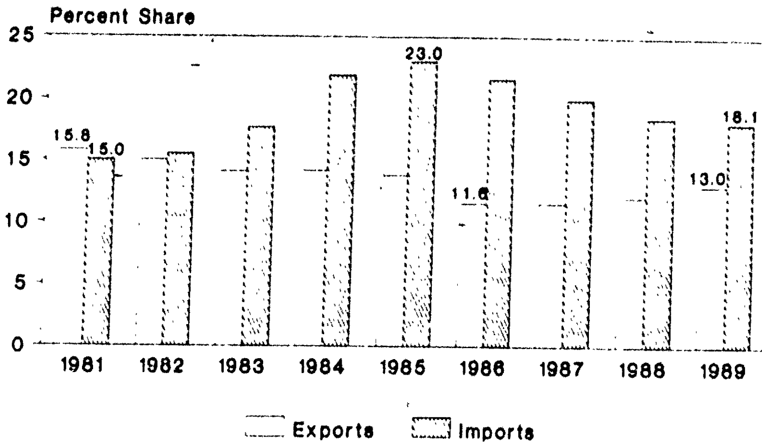
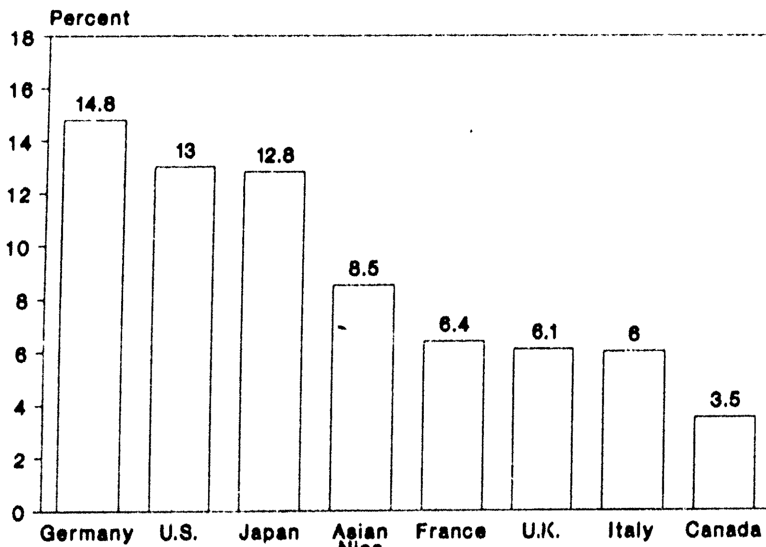


Figure 3
U.S. Shares of World Manufactures Exports and Imports 1981-1989

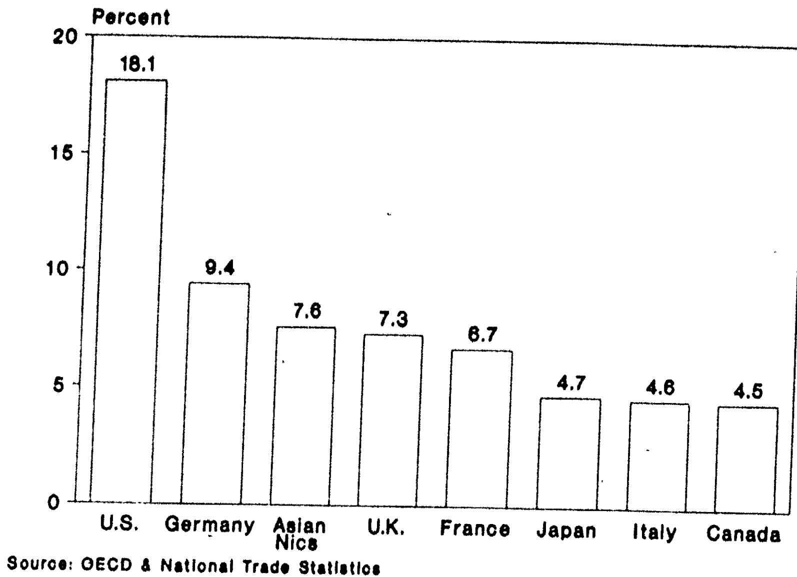


Source: OECD & National Trade Statistics

Figure 4
1989 World Manufactures Export Shares



Source: OECD & National Trade Statistics



STATEMENT OF THE COALITION FOR COMPETITIVE CAPITAL

My name is Kenneth L. Lay. I am chairman and chief executive officer of Enron Corp. in Houston, Texas. I appear before you today as chairman of the Coalition for Competitive Capital (CCC), a group of 21 major corporations dedicated to restoration of a permanent and effective 10-percent investment tax credit (ITC). The list of members of our rapidly-growing coalition is attached as Appendix A.

THE PROPOSAL

CCC recommends that Congress reinstate at the earliest opportunity a 10-percent ITC, targeted to that portion of producers' durable equipment integral to producing and transporting goods and energy, as well as to pollution control and other investment mandated for environmental purposes. Eligible assets would include equipment used in agriculture, agri-business, and manufacturing, as well as equipment that forms an important part of the nation's infrastructure, such as passenger and freight-carrying aircraft and railroad equipment operated by common carriers. The targeted ITC would not apply to furniture and fixtures, office equipment, executive jets, and the like. One of my favorite examples to make the essential case for targeting relates to a steel company investment in equipment: a new continuous casting process would be covered; purchase of a new desk for the CEO would not. This contrasts, of course, with earlier versions of the ITC, which covered all business assets except buildings. A partial list of the types of equipment that would and would not be eligible for the targeted ITC is attached as Appendix B.

However, critical to this proposal are two central points. First, there is no case either in terms of economics or equity to pay for a new ITC by raising other taxes on business -- that would hardly help the recovery we need and simply be a case of robbing Peter to pay Paul. Indeed, from an economic standpoint, a very strong case can be made against raising any taxes during this period of recession.

Second, to be effective, any new ITC must be creditable against the corporate alternative minimum tax. That tax, now hitting more than half of the nation's corporations, is strongly anti-investment and anti-growth, and I am very happy to see that the President has asked for

some relief from it. In the current instance, failure to apply any ITC benefits to reductions in AMT liability would sharply reduce the positive impact of the ITC.

Mr. Chairman, I shall return later in my statement to the case for targeting the credit, the importance of making it full rather than incremental and other issues specific to the proposal. First, however, I want to address the more fundamental questions of enhancing business investment, its role in economic growth and international competiveness, and the importance of tax policy in influencing such investment.

BUSINESS EQUIPMENT AND ECONOMIC GROWTH

Mr. Chairman, the long battle between the advocates of a market approach to solving mankind's economic problems versus state control and planning is over; markets and democracy are the clear winners. Central to this success has been the unmatched efficiency of the market system in facilitating the saving and investment that are the key to growth in jobs, output and living standards.

Yet not all market economies move at the same pace in providing good jobs and higher living standards. There are a large number of reasons for this disparity, but I suggest that Table 1 tells an important part of the story -- a story which, from the standpoint of the United States, is less than encouraging. Table 1 shows saving and investment rates in the major industrial democracies from 1973 through 1989. The U.S. ranks last on that list in every major category of saving and investment but two, where we are either next-to-last or tied with the United Kingdom. For example, our net rate of national saving was half that of Western Germany's and one-fourth the rate in Japan. Most important, in gross non-residential fixed capital formation -- the economist's long-winded way of saying business investment in plant and equipment -- the U.S. is at the tail end of the list. Moreover, if figures for the past decade alone were examined, we'd find that the U.S. had fallen back even more.

To highlight my point, Mr. Chairman, let me point out two things that will shock many Americans. First, total plant and equipment spending in Japan now exceeds that of the United States, even though Japan's GDP is no more than 60 percent of ours. Second, Japan has been investing twice as much per worker as the U.S. That's what we economists refer to as the depth of capital formation; in lay terms, it means that the tools Japanese workers have at their disposal are growing much faster than in this country. And, needless to say, those new tools are of the highest quality and most modern design.

Again, Mr. Chairman, it would be an overstatement to say that the negligible growth in U.S. real per capita income since 1973 has been caused solely by our sluggish investment performance. But it is a big part of the story, just as it in part explains the lack of resiliency of the U.S. economy in its struggle to emerge from recession.

THE CRUCIAL ROLE OF INVESTMENT IN EQUIPMENT

Defined very broadly, capital formation includes a wide variety of capital goods, that is, all assets which are consumed over a period of time rather than currently. Residential construction is a big part of U.S. capital formation, as is growth in commercial property. Inventories are capital, albeit of relatively short life. Business fixed investment -- plant and equipment -- is much more important to long-term growth in jobs and living standards than other types of capital formation. And within that total, producers' durable equipment is especially important.

This fact has been recognized for a long time. On the governmental front, it spurred some depreciation liberalization and reform in the Eisenhower years. But full recognition of the crucial role of equipment to economic growth did not emerge until John Kennedy became President. Two of his earliest actions prove this point. He directed the Treasury Department to modernize and liberalize the depreciation guidelines in two major industries and -- of overriding importance -- he asked Congress in early 1961 to enact a seven-percent ITC. President Kennedy viewed these actions as part of his campaign theme, "To get the country moving again," and to enhance U.S. competitiveness in international markets (yes, international competitiveness was a major concern of U.S. policymakers even as long as three decades ago).

Congress responded, albeit slowly and reluctantly, and approved the ITC in October 1962. Good things began to happen in the U.S. economy. Over the next several years, jobs rose rapidly,

inflation was held in check, and productivity grew at a record peacetime rate. To be sure, the ITC was only part of a whole complex of extremely well thought-out economic policies, but it was a very important part. (Those years of outstanding economic performance came to an end after 1965, however, as federal spending on both Vietnam and domestic programs rose sharply.)

All of us know the history of the ITC since those early days. The credit was turned off in 1966 but hastily restored in 1967; off-again, on-again in 1969-71; elevated to 10 percent in 1975 and "made permanent" in 1978. The ITC served as the linch pin of a highly effective and competitive capital cost recovery system enacted in 1981. It was finally repealed as a "tax loophole" in 1986.

Mr. Chairman, I dwell on these three decades of experience for two reasons. First, it shows that the ITC has not been a partisan issue; it is not, for example, surrounded by the controversy that complicates our approach to taxing capital gains. Second, the record shows that each time an ITC was turned on or improved, good things happened to the economy. Each time it was turned off, bad things happened.

SUMMERS AND DE LONG

Both common sense and the historical record tell us that the ITC should be a permanent part of our tax code. Now we have some solid economic research to support that view. In a research paper published by the National Bureau of Economic Research last year (see Appendix C for a summary), Professors Lawrence Summers and Bradford De Long of Harvard (you will recall that Professor Summers was chief economic adviser to Governor Dukakis in the 1988 presidential campaign) examined country-by-country patterns of economic growth. They concluded that investment in equipment is the single most important factor in a nation's economic growth and development. That is a very important conclusion in itself, and elevates equipment investment to a much more important role in economic growth than earlier scholars had thought to be the case. Even more startling is the finding that, for each one percent of GDP invested in equipment, the growth rate of that country's GDP will increase by one-third of one percent. That, Mr. Chairman, is a very high rate of return.

This does not mean that other factors are not important in the growth process. Human caital in the form of education and training -- unqualified workers cannot handle sophisticated tools -- is obviously crucial. Research and development is essential, as is efficient technology transfer. But the end-all and be-all of this effort in a modern market economy is a successful melding of all these forces to create more and better tools for the workers -- that is, modern, state-of-the-art machinery and equipment. In other words, human capital, technology, and the equipment itself -- all are essential to strong investment performance.

THE RECENT RECORD

An "eyeball examination" of the second line in Table 2 indicates that this country has not been doing all that badly in fostering growth in business equipment. That table shows that the growth rate in the stock of business equipment averaged between four-and-one-half and five percent in the years 1950-1979, and fell off to only 4.1 percent in the 1980's. But the overall figures are highly misleading; the disaggregated data tell an entirely different story. When information processing equipment is backed out of the total, the rate for the decade of the 'eighties drops dramatically, to only about one-third of the earlier periods.

What happened? Business went on a computer-spending spree in that decade. And that did not stop with repeal of the ITC in 1986 -- the price of computers dropped (relatively) so much that the repeal of the ITC, which would otherwise have increased the capital cost of such investment, was not noticeable. Not shown on the chart are the growth records of industrial equipment and airplanes, which also fell off sharply.

Is this to say that installation of ever-more efficient computers for accounting and other office purposes, "back-room" functions at securities firms, and a variety of financial-service functions is "unproductive?" Certainly not. But it can hardly be denied that, for the typical industrial firm, a new office computer adds much less to output per hour per person than an increase in equipment used directly in the process of production. And as for services, this promising area of economic growth must be viewed differently from industrial output when factors affecting international competitiveness are considered.

Stated simply, regardless of how competitive we become in the services sector, and even assuming that we are able to open some closed foreign markets sufficiently to compete in services on a level playing field, the key to long-run equilibrium in the balance of U.S. international accounts must rest primarily on industrial competitiveness. Perhaps the best explanation of "why manufacturing matters" must be strengthened is contained in Made in America, the excellent 1989 report of the M.I.T. Commission on Productivity. That commission said:

> ...some see a transition from manufacturing to services as an inevitable and desirable stage in the economic development of the nation, with the U.S. increasingly leaving manufacturing to other countries.
>
> We think this idea is mistaken. A large continental economy like the United States will not be able to function primarily as a producer of services in the foreseeable future. One reason is that it would have to rely on exports of services to pay for its imports, and this does not seem realistic. In 1987 gross U.S. exports of services were worth about $57 billion, whereas the total value of goods and services imported into the United States was about $550 billion . . . .
>
> The notion that the United States could eventually become almost exclusively a producer of services is all the more implausible when it is recognized that all of the manufactured goods now produced domestically would have to be imported (and hence paid for with exports of services) ... [while in fact] the long-term trend in the United States is toward increased demand for manufactured goods . . . .
>
> There is also reason to believe that if large sections of American manufacturing industry were ceded to other countries, high-wage non-manufacturing industries would follow them . . . .
>
> The United States thus has no choice but to continue competing in the world market for manufactures.

Turning back to the very slow growth in the stock of business equipment (less information processing) in the 1980s, we shall surely pay the long-run piper for this shortfall. We are perhaps paying it in the short run in the form of very sluggish recovery from a relatively mild recession.

That's the bad news. The good news is that Congress and the Administration can begin to turn the situation around. That turnaround involves meeting a long list of challenges, but the one of direct interest to this committee, is of course, tax policy.

TAXES AND BUSINESS INVESTMENT

Do taxes affect business investment decisions? That's a strange-sounding question to a corporate CEO, but the argument is still made that they do not. I regret to say that this argument is still given credence in some quarters. The only economic rationale I know supporting this view is the Keynesian hypothesis born in the depths of The Great Depression. Lord Keynes concluded that the primary (perhaps even sole) determinant of business investment was final demand for a company's products. This was understandable at a time when the prime bank lending rate was one-half of one percent, the Treasury bill rate one-twelfth of one percent, and tax burdens relatively low. In other words, capital costs were so low as to be no problem. The problem of the day was to stimulate consumer demand.

To be sure, forecasts of final demand are still very important in corporate decision-making as to capital expenditures -- but so are taxes. When we at Enron consider the initiation of a major investment project, we "scrub" the proposal until we have a pretty firm idea of the probable rate of return -- and that includes forecasts of final demand, degree of risk, etc. We then compare that so-called "internal rate of return" to the cost of the capital we will have to devote to the project. If the expected rate of return meets or exceeds the cost of capital, the project is in the ball park. If it falls short, the project is out of the game.

Taxes are not the most important element in our cost of capital; interest cost and cost of equity are most important, whether the financing is provided by attracting new debt or equity capital, or whether it is an opportunity cost incurred by financing the project out of cash flow.

But, at the margin, the tax hit on the income from the projected investment is important. An ITC significantly reduces that tax hit and thus reduces the cost of capital for a project. It also provides additional cash flow for projects through an immediate reduction in federal tax liabilities.

How important are taxes in business capital costs? Professor John Shoven of Stanford estimates them to be about 15 to 33-1/3 percent of the total. Another way to view their importance is to note that the Library of Congress estimates that the increase in taxes on new investment in equipment after 1981 raised the capital cost of investing in that equipment by 23 percent.

WHICH TAX TO CUT?

Professor Shoven has also helped us decide which business tax to cut to promote productive investment. In a 1990 study, he concluded that the ITC is by far the most cost-effective approach to promoting business investment in equipment. Why is the ITC superior to a cut in the general corporate tax rate for this purpose? Because a company earns the ITC only if the new investment is made. On the other hand, a cut in the general corporate rate reduces the tax take on a huge volume of old, existing investment as well as new investment. In other words, the ITC works at the margin, where it is most effective.

But, some critics argue that accelerated deprection also works at the margin, by applying only to new investment, and is just as effective an as ITC. The important difference is that the ITC is a once-and-for-all cut in taxes that both reduces capital costs and enhances cash flow in the year the equipment is acquired. Accelerated depreciation is in essence an interest-free loan to the company, but it must be paid back through slower depreciation in later years. Capital costs will be reduced some, and cash flow enhanced, but not nearly so directly and effectively as with an ITC.

IS THE ITC A TAX "LOOPHOLE"?

Critics also charge that the ITC is a tax "loophole" for business, and that its restoration would renew the tax shelter business. Actually, a new ITC would simply help eliminate one of the three layers of taxation of business saving involved in our existing tax system. For every $1,000,000 in taxable income that Enron earns, it pays a tax of $340,000, regardless of the amount of that income that is retained (this is business saving) as opposed to being paid out as dividends. If those retained earnings are invested in a successful investment project, the earnings from that investment will be taxed at 34 percent. Then, finally, when we pay out dividends, our stockholders are taxed at their applicable individual rates. Or, if they sell the stock at a profit, they are taxed at the capital gains rate.

Enactment of an ITC will not wholly eliminate this unjustified and unwise overtaxation of saving and investment, but it will help ameliorate it.

Nor will restoration of the ITC in the targeted form we recommend revive the tax shelter business. To be sure, a new ITC would help some marginally profitable industries, such as airlines, obtain new and better airplanes through leasing them from financial service companies. But that is a long-standing finance mechanism which is widely accepted and hardly qualifies as a "tax shelter." To the extent tax shelters were built around the ITC before its repeal in 1986, they were primarily related to equipment in the offices of professionals, such as dentists and doctors. Such equipment would not be eligible for the targeted ITC which we support. Furthermore, if deemed necessary, limitations could be imposed to deny the ITC for partnerships which solicit investors in the usual form of tax shelters.

CUTTING THE COST OF THE ITC

The major problem with restoring the ITC is, of course, the cost -- upwards of $36 billion per year if enacted at the 10-percent rate and applying to all business equipment (as defined in the previously existing stature). This cost can be cut dramatically in two wholly legitimate ways, and that's what our proposal would contemplate.

First, targeting the ITC in the manner proposed will cut the cost by more than half. Simulations by the respected econometrician, Dr. Allen Sinai (see Table 3), indicate a reduction in the first full fiscal year (1993) from upwards of $36 billion per year to about $13 billion.

Second, "scoring" the action dynamically rather than statically will further reduce the cost in the first full year to just $11 billion. I would strongly urge the dynamic scoring, Mr. Chairman, as would the vast majority of businessmen. It simply does not make sense to enact a measure -- such as restoration of the ITC -- which Congress believes will boost the economy and then not allow for the increase in revenues that increased activity will engender.

Again referring to the Sinai simulations, the FY1992 impact of our proposals, if effective February 1, would be only $8.0 billion on a static basis and $6.7 billion on a dynamic basis.

Although these are very small amounts for an action that Sinai estimates (Table 3) will raise investment in targeted equipment by a cumulative 23 percent above baseline by 1997, the amounts still have to be covered under "pay-as-you-go" budgetary rules.

HOW DO WE PAY FOR THE NEW ITC?

A permanent, targeted 10-percent ITC is much more powerful than the temporary nontargeted Treasury proposal for a one-year "investment tax allowance" (ITA). For example, Sinai estimates that the ITC approach would cut capital costs of equipment investment by 11.3 percent the first full year, rising above 12 percent thereafter. Laurence H. Meyer and Associates estimates the capital-cost impact of the Treasury's ITA at less than 2 percent and then only for the temporary period.

The funds now allocated by the Administration to the ITA ($6.1 billion in FY1992) could instead be applied to the new ITC, with any small shortfall in the near term -- and the full cost over the long term -- covered by revenues released by cuts in defense spending. There are convincing reasons for applying a reasonable but not large portion of the "Peace Dividend" to restoration of a proven device for providing tools for American workers.

Using part of the Peace Dividend to fund a new ITC is sort of a modern version of the Biblical phrase, "...and they shall beat their swords into plowshares." Using funds from the defense budget should be viewed as "beating swords into more tools -- and better tools -- for American workers." The CCC has no position on the appropriate level of defense spending -- that should be left to defense experts and the democratic process. But there is discussion of a cut in defense spending from the current 5.4 percent of GNP to four percent or less. Given a GDP of about $5.7 trillion, the peace dividend that might be realized over the next few years looms very large indeed -- upwards of $100 billion per year.

Viewed in this way, restoration of an effective 10-percent ITC is fully justified and eminently affordable.

THE NEW ITC SHOULD BE PERMANENT AND NONINCREMENTAL

Mr. Chairman, some proponents of a new ITC have fashioned proposals that would conserve revenue either by making the credit temporary or applying it incrementally (that is, only the amount of new investment over that of some stipulated base period would receive the credit.) We are convinced that, reflecting the nature of business decision-making, a temporary ITC would do little more than move ahead in time some spending that would take place later, thus doing little at all for long-term growth.

We are especially opposed to the idea of an incremental ITC. Our Coalition consists of aggressive investors -- companies that have been willing to risk the ire of stockholders who favor increased dividends over the retained earnings that are the source of much corporate investment. An incremental ITC would unduly reward the sluggish investors of earlier years and penalize companies which have kept their investment up.

That's simply not fair.

CONCLUSION

Mr. Chairman, the record, economic analysis, and common sense support the view that we need a new ITC. It is tried and true. It has many friends in Congress and is truly nonpartisan. Targeting the credit to productive equipment will sharply reduce the cost but give up very little of its strong "bang-for-the-buck" impact on business investment in productive equipment. The new

ITC can be installed on a permanent, non-incremental basis, fully and soundly paid for by substitution of the Treasury-designated ITA revenues for that purpose, plus a reasonable but not large share of the Peace Dividend.

Mr. Chairman, the Coalition for Competitive Capital recommends enactment of a permanent, targeted 10-percent investment tax credit at the earliest possible date.

APPENDIX B

Eligible Property (Excluded vs. Included)

Excluded

Buildings & structural components, and "section 1250 class property" in general.

Any machinery & equipment used in the following business activities:

- Retail and wholesale trade
- Services businesses in general (including banking, financial, insurance, legal, medical and accounting)
- Recreation activities
- Theme and amusement parks

The following machinery equipment — by asset type — used in any business activity:

- Office furniture, fixtures, and equipment
- Office-type data handling equipment (except computers used for certain types of research)

Illustrative examples of excluded assets:

- Store counters, display cases, racks & shelves
- Billboards & signs
- Regular air conditioners
- Restaurant tables & kitchen equipment
- Barber chairs
- Hotel beds & furniture
- Regular light fixtures

Included

All machinery & equipment integral to (i) producing products or energy in the U.S. or performing relating research, or (ii) providing essential transportation, communications, waste disposal services.

Illustrative examples — machinery & equipment used in any of the following activities:

- Agriculture and fisheries
- Timber cutting, saw milling and manufacture of wood products
- Mining and extraction
- Oil & gas exploration, drilling & production
- Petroleum refining
- Grain milling
- Construction
- Steelmaking & manufacture of non-ferrous metals
- Metal fabrication
- Pulp & paper production
- Automobile & vehicle production
- Manufacture of chemicals
- Production of rubber & rubber products
- Shoe & leather products
- Manufacture of plastic & plastic products
- Production of medical supplies & drugs
- Production of glass, stone, and clay products
- Foundry work
- Machine tool production

Excluded

- Dental chairs & drills
- Checkwriters
- Automatic-teller machines
- Vending machines
- Bank vaults
- Word processors
- Photocopiers
- Desk-top computers (except if used for certain types of research)
- Office furniture, fixtures, & equipment, such as (a) oriental rugs (b) art work (c) desks (d) chairs
- Car washes
- Books in a law office
- Films & tapes
- Escalators
- Elevators
- Carousels
- Rollercoasters
- Pool & billiard tables & equipment
- Bowling balls & pinsetting machines
- Ski lifts
- Theater seats & other theatrical equipment
- Motion picture projection equipment
- Exercise equipment
- Tennis nets
- Plus: an array of other similar assets not integral to production, manufacturing, etc.

Included

- Manufacture of electronic, electrical & other mechanical products
- Manufacture of food products
- Aerospace manufacture
- Shipbuilding
- Production and transmission of electricity, gas & steam
- Air and land transportation services
- Telephone, telegraph & communications services

Further illustrative examples — specific assets included:

- Airplanes
- Continuous casters (steel)
- Railroad equipment & track
- Drilling rigs
- Computers used for research pertaining to included activities
- Computers that run assembly lines or are otherwise integral to production or manufacturing
- Farm tractors
- Laboratory equipment
- Looms
- Printing presses
- Rolling mills
- Auto assembly lines
- Lathes
- Trucks, buses, taxis used in passenger or freight hauling businesses or integral to production, manufacturing or extraction

STATEMENT OF PITNEY BOWES INC.

Summary

Existing foreign tax credit rules discourage U.S. corporations from investing foreign subsidiary earnings back into the U.S. economy. To avoid double taxation of foreign earnings, U.S. multinational corporations are forced to leave potential investment dollars offshore. More specifically:

Expense allocation rules under Section 861 of the Internal Revenue Code negatively impact investment in the U.S.

The foreign tax credit computation can cause U.S.-based multinational companies to forego the repatriation of foreign earnings to the U.S.

The five-year limitation on the carryover of excess credits is too short and exacerbates the exposure of U.S. companies to double taxation of their foreign earnings.

Subpart F rules put U.S.-based multinationals at a competitive disadvantage to foreign-based companies because cross-border transactions of U.S.-based companies are subject to possible double taxation in markets such as the European Community.

This statement will present our specific concerns. It is our position that the entire methodology for computing the foreign tax credit needs to be reviewed. We also believe that various temporary solutions may be available which will have little impact on government revenues but provide significant encouragement for domestic investment by U.S. corporations. One example, which will be further explained in this statement, is the creation of an elective Section 904 basket for dividend income from treaty-based countries to which no expenses would be allocated.

Background

Pitney Bowes Inc. is a $3.3 billion multinational manufacturing and marketing company. It is headquartered in Stamford, Connecticut, and conducts its research and development and manufacturing in Connecticut, Florida and Ohio.

The U.S. tax rules are restricting our ability to compete fairly against foreign-based multinationals. From a tax perspective, our competitors are based in countries where the tax laws are better suited to cross-border competition and capital investment than the United States. If we are to compete on an equal basis, it is critical that Congress recognize the need to provide U.S. companies with incentives to create jobs and stimulate capital investment in the United States.

Interest Allocation Rules

The negative economic impact of these rules is most evident for manufacturers who have captive leasing companies to help finance their products. Pitney Bowes Inc.'s subsidiary, Pitney Bowes Credit Corporation, incurs substantial interest expense in the U.S. to finance U.S. purchases of Pitney Bowes products. It also incurs interest expense to support the U.S. leasing of third-party products. Since 1986, the interest expense incurred to support the lease of these products is required to be allocated to foreign source income, thereby reducing our allowable foreign tax credit and effectively eliminating a portion of our interest deduction.

The activity of leasing U.S. products requires the company to incur interest expense. Pitney Bowes Credit Corporation's interest expense is based on its own wholly domestic operations and financial performance. Accordingly, their interest expense has nothing to do with Pitney Bowes Inc.'s international operations. Moreover, while part of Pitney Bowes Credit Corporation's interest expense is considered foreign source, its income is entirely treated as U.S.-source income.

We understand that the current interest allocation rules were created to eliminate loopholes that existed prior to the 1986 Tax Reform Act. However, the treatment of U.S. interest expense as if such interest supports both domestic and foreign operations unfairly penalizes companies like Pitney Bowes.

By allocating interest expense to foreign source income, Section 861 effectively eliminates a portion of the tax benefit attributable to deduction of interest expense by disallowing a portion of the foreign tax credit. Thus, by eliminating a portion of the interest deduction, the interest allocation rules increase the cost of capital in the United States and also make it more attractive to invest in certain foreign markets such as Canada, the U.K. and Germany, where the income attributable to such investment is foreign source. Furthermore, since foreign treaty partners do not have similar rules on the allocation of interest, it clearly places U.S. companies at a competitive disadvantage when competing against foreign-based multinationals operating both in the U.S. and abroad.

Allocation of R&D Expenses

The partial allocation of research and development expenses in the U.S. to foreign sources also creates a disadvantage for U.S. companies looking to compete internationally. The United States should encourage companies to conduct R&D in the United States. By requiring R&D expenses to be partially allocated to foreign source income, the tax rules effectively reduce the attractiveness of U.S.-based research and development by disallowing a portion of the deduction through the loss of foreign tax credits. On the other hand, many of our treaty partners offer incentives for R&D to be conducted in the local jurisdiction. Therefore, like the interest allocation rules, these rules penalize U.S.-based manufacturers when compared to foreign-based companies.

We hope that Congress will extend the R&D tax credit and the partial direct allocation of R&D expenses to U.S. sources. However, the current allocation of sixty-four percent of R&D expenses to U.S.-source income is only a partial solution. Even with extension of both the sixty-four percent allocation and the R&D credit, a loss of foreign tax credits can still occur and in many cases more than offset any benefit from the R&D credit. Thereby, extension of the current R&D rules will not totally remove the tax incentive for U.S.-based multinationals to conduct foreign R&D.

Impact on Repatriation of Foreign Earnings

The loss of the tax benefit attributable to U.S.-based expenses through the foreign tax credit also acts as a disincentive to repatriate foreign subsidiary earnings to the U.S., since the repatriation crystallizes the U.S. company's exposure to double taxation. Therefore, companies are better off in many cases investing surplus cash outside the United States. This situation is compounded for U.S.-based multinationals looking to expand and compete in foreign markets. In many cases, multinationals in an expansion stage may have foreign source losses as a result of having too many expenses being allocated to foreign source income and not enough low-taxed foreign source earnings during the early stages of international expansion. These losses are then carried forward indefinitely.

Generally, this problem can be exemplified where a controlled foreign corporation operating in a high-tax jurisdiction has substantial earnings which have been subjected to tax by the local taxing jurisdiction. Upon payment of the dividend, the income is subject to tax in the U.S. The taxpayer is provided with a foreign tax credit against its U.S. tax liability in order to avoid double taxation on that dividend income. The foreign tax credit is limited to the net foreign source income of the U.S.-based multinational multiplied by its effective U.S. tax rate. Therefore, the U.S.-based multinational will lose a portion of its credit, because the expenses allocated under Section 861 reduce the company's foreign source income. Because the taxpayer cannot claim a full foreign tax credit, the

dividend income is subject to U.S. tax and the company is forced to record tax expense for financial accounting purposes. In addition, the dividend is likely to create excess foreign tax credits which can only be carried over for five years, after which they will expire if not utilized.

Accordingly, in the above situation there is incentive for many U.S.-based multinationals to avoid recording negative impacts to earnings by foregoing dividend payments to the U.S. and, in effect, reinvesting such funds outside the U.S. The beneficiary of such capital investment generally is the U.S.-based multinational subsidiary and, accordingly, the earnings on such funds are taxed by the foreign country and go to the benefit of the foreign nation's economy.

Subpart F Impact

The Subpart F rules also present a major stumbling block for Pitney Bowes to overcome as it devises its strategy in response to EC-92. These rules can transform profit realized by controlled foreign corporations from cross-border transactions into deemed dividends for U.S. tax purposes. Accordingly, U.S.-based entities trying to take advantage of foreign operational synergies such as centralized marketing, purchasing and other functions, are faced with possible double taxation of their earnings under some extremely complicated rules.

The Subpart F rules should be revised to permit U.S. companies to better compete in international markets, especially where country barriers are being eliminated. While full benefit to European companies from the consolidation of the European Community has not yet been realized, these companies are currently formulating their plans and finalizing their strategies. Clearly, U.S. multinationals cannot afford to be at a disadvantage and act after the fact. The Subpart F rules should be revised to reflect the European Community as one country, and the laws should be changed to be flexible enough to recognize the formation of other economic compacts around the world.

Recommended Congressional Action

We ask that Congress examine these rules and make changes where necessary to both stimulate U.S. economic growth and improve the competitiveness of U.S-based multinationals. In the meantime, suggestions for immediate legislative relief which should have minimal or no impact on government revenues include:

1) Elective Special Basket For Dividends. On an elective basis, taxpayers would be permitted to group certain foreign dividends in a special basket under Section 904 of the Internal Revenue Code. This special basket would not be impacted by the interest expense allocation rules or any other expense allocation rules under Section 861. This election should be permitted for dividends and Subpart F income from controlled foreign corporations operating in countries which have treaties with the U.S., and certain countries with high effective tax rates. Royalty and other low-taxed foreign-source income would not be eligible to be combined with such dividend income for purposes of the foreign tax credit computation. The new dividend basket would also not be offset by losses in other Section 904 baskets.

   Generally, multinational companies would make this election when it is necessary to avoid a negative impact upon the repatriation of intercompany dividends. Companies would not need to use this election when they have sufficient sources of low-taxed foreign source income, without including dividends, since these companies can generally fully utilize their foreign tax credit to offset their U.S. tax liability on such dividend income. Accordingly, by permitting this new election, U.S. companies would no longer be restricted by the expense allocation rules when deciding whether to repatriate funds earned outside the United States. The penalty of double taxation of Subpart F income would also be diminished.

The above election is only a temporary measure to help U.S.-based multinationals. Because it should stimulate dividends from controlled foreign corporations back to the United States, it should help improve the availability of capital in the United States. In addition, because most U.S.-based multinationals making this election would generally only do so to repatriate foreign earnings, we believe there would be no drain on government revenues.

2) Changing the Subpart F Rules for EC-92. We respectfully recommend that the Subpart F provisions of the Internal Revenue Code be changed to reflect the consolidation of the European Community as one economy. We also hope that Congress will recognize that other regions around the world are also looking to form compacts and remove their cross-border barriers, and our rules should be amended to be flexible enough to permit U.S.-based multinationals to compete on an equal basis with foreign-based multinationals in these new environments.

3) Extension of the Foreign Tax Credit Carryover Provision. Immediate consideration should be given to permitting an extension of the foreign tax credit carryover rules to beyond five years. This would eliminate the potential exposure to companies triggering excess credits from dividend repatriations.

Conclusion

In this statement, we are addressing the impact of the foreign tax credit rules on U.S.-based multinational companies. We wish to note that this is only one area of the tax code that needs to be revised to improve competitiveness. Accordingly, we also wish to briefly note our support for other tax changes which will stimulate the economy, such as making permanent the R&D tax credit, reinstituting a permanent investment tax credit, and eliminating some of the adjustments in computing the Alternative Minimum Tax, such as ACE depreciation.

STATEMENT OF THE OKLAHOMA STEEL AND WIRE COMPANY, INC.

Oklahoma Steel and Wire Company, Inc. produces wire products such as fence panels and fencing, directly employing 175 people. OK Steel purchases inputs from both domestic and foreign steel producers. To compete with domestic and foreign producers of these wire products, it is critically important to OK Steel that these inputs be freely available at fair market prices. Furthermore, OK Steel imports raw materials and finished products and attempts to export finished goods. This experience qualifies OK Steel as particularly well-suited to provide the Committee with the practical business perspective of those impacted by the broad economic and fiscal policies affecting the international competitiveness of U.S. companies.

Two factors involving U.S. trade policy have hindered companies such as OK Steel in their efforts to export in an increasingly global market: First, efforts to negotiate free trade agreements and multilateral agreements affecting trade in steel products have, by and large, failed to address non-tariff barriers to trade; and, second, the U.S. corporate tax structure places potential exporters at competitive disadvantage while effectively encouraging imports. These competitive impediments are purely the function of governmental action and do not indicate a fundamental lack of competitiveness of U.S. industry. Quite contrary -- these aspects of U.S. trade and tax policy have, in fact, created a situation where otherwise internationally competitive companies cannot compete in either the international or the domestic market.

OK Steel's export opportunities logically lie primarily in the Mexican export market. As such, the following comments focus largely on the aspects of that market and the impediments to U.S. competitiveness. It is important to note, however, that the situations and problems described below, while focusing on Mexico, are by no means isolated occurrences. We believe that these comments are indicative of the larger adverse effects on U.S. competitiveness fostered by U.S. trade and tax policy.

The Mexican Market and Structural Impediments to U.S. Competitiveness

A surge in import from Mexico led the U.S. to amend the 1985 Voluntary Restraint Agreement ("VRA") with Mexico to include wire products in the coverage of that agreement. This coverage was continued in the re-negotiated steel VRA with Mexico, although Mexico's quota for wire products was more than doubled.

The rapid increase in imports of wire products from Mexico might lead the Committee to conclude that OK Steel seeks protection from imports -- quite the contrary. OK Steel welcomes competition from the Mexican producers and asks only that the conditions under which this competition occurs are fair so that U.S. exporters have the same opportunity to sell products in Mexico as the Mexican producers enjoy here in the U.S.

OK Steel shares the excitement expressed by many U.S. companies over the economic reforms initiated by the Government of President Carlos Salinas. We believe that **fair and open** trade creates business opportunities and business opportunities create jobs on both sides of the border. The elimination of tariff and non-tariff barriers to trade enables the healthy free market mechanism to act as the arbiter of commercial existence on the basis of overall competitiveness as opposed to non-market oriented protective devices.

As this Committee is well aware, Mexico has not always been open to imports from the U.S., or for that matter, any country. Until relatively recently, Mexico followed the classic export-driven economic development model based on import substitution policies. Today, we are happy to acknowledge, the products of OK Steel face no significant licensing and other non-tariff barriers to trade.

That does not mean, however, that OK Steel has effective access to the Mexican market. OK Steel's exports face two different problems: first, effective rates of import duties and other charges close the Mexican market to our exports; and second, Mexican producers have a huge financial incentive to export to the United States that is not reciprocated due to U.S. tax law. As we understand the goals of the proposed trade negotiations, only the former access barrier is confronted. In order to provide meaningful benefits to U.S. producers from a FTA, the latter problem must be addressed.

A Substantial Effective Rate of Protection Currently Precludes Products from the Mexican Market

With the elimination of non-tariff barriers such as import licensing, tariffs and other border charges became the primary obstacles to penetrating the Mexican market. By 1986, across the board tariff reductions were undertaken. Maximum tariffs were reduced from 100% to a bound rate of 50%. Applied rates were reduced further so that today Mexico imposes duty rates of 10% or 15% on the products produced by OK Steel.

A review and comparison of the current Mexican and U.S. tariff rates reveals that the differential between Mexican and U.S. duties imposed on wire products is substantial, ranging from 4.4% to 15% of the value of the product. Wire products are extremely price sensitive -- a price difference of only a few percentage points caused by import duties often means the difference between making and losing a sale. For that reason, OK Steel welcomes the possibility of reducing tariff rates between the U.S. and Mexico to zero -- when the costs associated with trade are reduced, both trading partners benefit. If import duty rates are equalized between the U.S. and Mexico, a significant and effective barrier to entry will be eliminated.

Mere tariff reduction, however, is not enough. In reality the effective rate of protection in Mexico is much greater for the following reasons:

1. Mexico's bound rate for these products is 50% *ad valorem*; thus, at any time Mexico could increase its tariffs to that level without any legal obligation under the GATT.

2. Mexico assesses a Customs Service Fee of 0.6% (0.8% on Sundays). A 1986 GATT Working Party found this practice to be inconsistent with both Article III, the national treatment clause of the GATT, and Article VIII which requires that such fees "shall be limited in amount to the approximate cost of the services rendered and shall not represent an indirect protection to domestic products or a taxation of imports or exports for fiscal purposes." Later, a GATT Panel found that the U.S. customs user fee, when it was applied at 0.22%, was excessive; presumably a fee three or four times higher would clearly run contrary to GATT rules.

3. Mexico assesses a Municipal Tax (equivalent to a local import duty) of 3% of the Federal duties.

4. Mexico also collects a Value Added Tax (VAT) known as the IVA, of 15% on all wire products of interest to OK Steel. This tax is applied to the "normal customs value" of the good plus duties, the customs processing fee and the municipal tax.

As a result, the current effective rate of protection is not 10% or 15% but rather exceeds 33%. A simple illustration may assist the Committee in understanding this point:

CIF Value of steel export to Mexico	$ 1000.00
Federal Import Duty (15%)	$ 150.00
Municipal Tax (3% of duties)	$ 4.50
Customs Service Fee (0.6%)	$ 6.00
Subtotal	$ 1160.50
VAT (15%)	$ 174.08
Total	$ 1334.58
Total Mexican Taxes and Duties	$ 334.58
Effective Rate of Protection	33.46%

None of these measures necessarily violates Mexico's international obligations -- although the Customs service fee certainly appears inconsistent with GATT requirements. Rather, the cumulative effect of these duties, fees, taxes and surcharges is so great that the conditions of trade in galvanized wire, barbed wire, wire mesh and fence panels are inherently unequal between the U.S. and the Mexican markets. In other words, there is no level playing field in these products.

OK Steel strongly supports negotiations aimed at eliminating these barriers to free and fair trade between the U.S. and Mexico. If aimed only at the elimination of tariffs, however, the FTA would only partially reduce this effective rate of protection, because, as the following discussion indicates, the VAT imposed by Mexican authorities on U.S. exports to Mexico creates a substantial effective structural barrier to U.S. exports.

Disparate U.S. and Mexican Tax Policies Provide an Incentive to Export to the U.S. and an Effective Barrier to Exports to Mexico

On the other hand, Mexican producers have an incredible incentive to export to the United States. The VAT or IVA mentioned above is rebated upon export. In effect, therefore, a Mexican producer gets a 15% bounty just for exporting his product to the U.S. Under these circumstances, why should the rational Mexican producer sell in the home market when he can export to the U.S. and have even greater pricing flexibility?

The rub of the issue, however, is not the economic effect and the incentive to export created but rather that the Mexican practice is not only condoned but encouraged by the GATT. In this instance the exporter receives money from the government conditioned upon exportation -- the classic definition of an export subsidy. According to a long-standing theory concerning the effects of indirect and direct taxation (taxes imposed on goods as opposed to taxes imposed on income), the non-excessive rebate of indirect taxes upon exportation is permitted under GATT rules.

This situation would not be disturbing if U.S. companies such as OK Steel enjoyed the same rebate possibilities. In fact, the theory behind the rebate of indirect taxes is quite simply one of tax neutrality. Exporters should not be placed at a competitive disadvantage by home market taxes. The rebate of indirect taxes is a "border tax adjustment" devised to permit exporters to enter the international market on a level domestic tax playing field.

The problem, of course, is that the U.S. does not impose indirect taxes (other than some excise taxes unrelated to this product) preferring instead to raise revenue almost exclusively through direct income-based taxes. As a result, the U.S. literally has nothing to rebate to exporters such as OK Steel. Virtually every other significant U.S. trading partner uses indirect taxes and GATT-legal rebates. Mexican producers, due to the VAT rebate, have an incentive to export to the U.S. precisely because the U.S. does not impose an indirect tax on products and imports. Since the U.S. producer's price already reflects the direct taxes imposed by the U.S. and the Mexican company has had this component of its costs removed, the Mexican company, assuming an otherwise similar cost structure, has significant pricing discretion.

Some might find it incongruous for a rational businessman to seemingly suggest new taxes. Quite the contrary. OK Steel argues simply for a rational system of taxation that does not penalize its exporters. The current U.S. tax policy of utilizing direct taxation and avoiding indirect taxes places U.S. companies interested in exporting at a competitive disadvantage. Thus, Mexico is not wrong in its VAT rebate -- the GATT condones this practice. Perhaps the GATT rules are faulty -- but there seems no interest in changing the distinction between direct and indirect tax rebates.

The answer, it seems, springs from the possibilities for the substitution of certain direct U.S. taxes with an alternative form of taxation based on indirect taxation associated with the revenue from the product sold, as opposed to the overall income generated by the enterprise. A debate on this issue has raged for years with many economists insisting that freely floating exchange rates eliminate any such discrepancy. This conundrum cannot be solved in the sterile, assumption-laden vacuum of

theory. The simple business reality is that under the circumstances faced by OK Steel, Mexican wire producers are "paid" to export their product to the U.S. while U.S. products pay the very Mexican VAT that is rebated upon export.

Even if all tariffs and customs fees were eliminated in the context of the FTA, OK Steel would continue to face a 15% *ad valorem* barrier to its products when exporting to Mexico due to the Mexican VAT imposed on imports. OK Steel's Mexican competitors, on the other hand, face no such barrier when exporting to the U.S. The way to level the playing field is clear -- impose an equalizing tax at the border (a recapture of the Mexican rebate through a U.S. duty) or at the point of sale (an indirect tax or VAT applied to imports). For this reason, OK Steel views the recent discussion of the Business Transfer Tax or Uniform Business Tax as a step in the right direction, if such a tax structure could be created consistent with the GATT rules on rebates of indirect taxes.

In light of the Uniform Business Tax proposal, we wish to draw your attention to the testimony of Ernest S. Christian, Jr. before the Committee on June 19, 1991. In our opinion, Mr. Christian provided the Committee with a superb assessment of the negative effects of the current federal corporate income tax structure on U.S. international competitiveness.

It is important to note that the Free Trade Agreement with Canada was negotiated when there was no VAT in Canada. Since that time, the Goods and Services Tax (the Canadian form of the VAT) has been imposed. While OK Steel has no first hand knowledge of the effects of the GST on bilateral trade under the FTA, we believe that the problems identified with regard to the disparate tax structures of Mexico and the U.S. are now being experienced in bilateral trade with Canada.

Conclusion

As noted earlier, OK Steel does not begrudge foreign wire product producers a shot at our market. On the contrary, OK Steel welcomes competition under fair conditions. However, in the case of Mexico for example, U.S. wire products producers lacks even a semblance of reciprocal access to that market. An FTA with Mexico will substantially eliminate many of these trade distorting practices and remove the barriers companies such as OK Steel face in exporting to Mexico. Before the U.S. permits unfettered access for Mexican wire products, however, the structural incentives encouraging Mexican exports to the U.S. market must be eliminated.

It is time to recognize that U.S. trade policy is not distinct from tax policy. In an increasingly borderless commercial world, the U.S. tax structure unduly skews trade flows at the expense of American jobs and competitiveness. Congress should confront and remedy the inherent competitive disadvantage imposed on American exporters and take full advantage of GATT rules regarding border tax adjustments. This is not a question of Mexican and Canadian practices that inhibit imports, but rather a question of American tax practices that restrict exports. The U.S. cannot afford to be the silent player in a NAFTA where the other parties have significant incentives to abandon their domestic markets, export to the U.S., and thereby eliminate American jobs. It is time to recognize that a rational U.S. tax and trade policy should focus on efforts to export goods and services and not jobs.

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