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ECONOMIC GROWTH AND THE PRESIDENT'S BUDGET PROPOSALS

HEARINGS

BEFORE THE

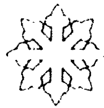
COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

FEBRUARY 12 AND 13, 1992

(Part 1 of 2)



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ECONOMIC GROWTH AND THE PRESIDENT'S BUDGET PROPOSALS

WEDNESDAY, FEBRUARY 12, 1992

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

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Riegle, Breaux, Roth, and Chafee.

[The press release announcing the hearing follows:]

[Press Release No. H-6, Feb. 3, 1992]

SENATOR BENTSEN CALLS HEARINGS ON ECONOMIC GROWTH, PRESIDENT'S BUDGET, FINANCE CHAIRMAN CITES NEED FOR SWIFT ACTION

WASHINGTON, DC—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, Monday announced a series of hearings on economic growth and the President's budget proposals.

Bentsen (D., Texas) said the hearings will be at 10 a.m. on *Wednesday and Thursday, February 12 and 13 and Tuesday and Wednesday, February 18 and 19* in Room SD-215 of the Dirksen Senate Office Building.

"The Finance Committee held hearings last November and December to examine the state of our economy and help us plan action for turning our economy around. The President submitted most of his budget proposals last week and now we need to take a close look at them," Bentsen said.

"Our economy is in a rut. Growth in our Gross Domestic Product was a tiny 0.3 percent in the fourth quarter and consumer confidence, as measured by the Conference Board, is at its lowest level since May 1980. We're having to extend emergency unemployment compensation benefits yet again because unemployment continues to rise. Jobs and the economic health of millions of Americans hang in the balance.

"These hearings will provide a wide range of views on how best to invigorate our economy. We'll examine the President's proposals for tax increases and cuts, for health care and how his budget would affect our economy," Bentsen said.

"I intend to move as quickly as possible to pass legislation to help American families get the help they need. These hearings on growth proposals, including the President's budget, will help move that process forward," Bentsen said.

Bentsen said Administration witnesses will testify on the President's tax proposals on February 12; the February 13 hearing will include testimony from economists and private sector representatives regarding how tax proposals offered by the President and Congress will affect the economy in the short and long term; the February 18 hearing will have Administration and private sector witnesses discussing the President's health proposals; Members of Congress and additional witnesses will testify on February 19.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. If you will please be seated, gentlemen, we will get under way. For the moment, as I look at the membership, we will deal more in quality than quantity. But we will have more members here as we go along.

I want to welcome the administration's economic team: Secretary Brady, Mr. Boskin, and Mr. Darman. We welcome you to this hearing on the President's economic package. You are going to find this committee, I think, eager to work with you in trying to have an effective economic program put on the books.

But I must tell you that as I looked at the election year budget, it seems to have a lot more sweetener and not enough substance. Trying to look at what effect it is going to have on the deficit, it certainly is not going to rein it in.

The budget shows the deficit declining to $180 billion by 1996. But then it starts to grow again. I must say, Mr. Darman, you are innovative and creative when it comes to some of these assumptions in this budget. We face a tough situation here in the Senate when we look at some of the accounting practices that you are talking about putting into this. And we look at the estimates of the Congressional Budget Office and the Joint Tax Committee, which we are obligated to follow, and then some of the estimates of what this does, insofar as the deficit coming from the administration.

There is real reason to question whether this budget will get the deficit down anywhere close to $180 billion before it begins to shoot back up. It purports to save almost $29 billion through 1997 by using, I think, outdated economic assumptions.

It proposes some vaguely defined caps on entitlement programs such as Medicare and Medicaid. It claims, on the one hand, that they will be used to reduce the long-term budget deficit. And, on the other hand, they are going to be used to pay for the President's health care package.

The administration claims the President's proposed tax cuts would cost less than $25 billion over 5 years, while the Joint Tax Committee, that we are obligated to follow, pegs their cost at more than twice that.

No question this economy needs a boost. I think it teeters on the edge of a double-dip recession with the vast weight of the economic evidence pointing to a muddled recovery in the months ahead. You have organizations like the U.S. Chamber of Commerce continuing to forecast negative growth this quarter.

And you get this drumbeat of layoffs by blue-chip companies like GM and IMB continuing—3,000 jobs a day lost in January. Consumer confidence is at a low not recorded since 1980 on that chart. You have to go all the way back to 1980 to see it that low.

The index of leading economic indicators forecast no recovery before summer, if then. And Mr. Boskin, the President's own budget projects growth of only 2.2 percent this year. That is by far the weakest growth of any economic recovery since World War II.

And you can see the kind of real growth during recoveries and what happened before it. The average of post-war recoveries, ex-

cluding 1980 and 1981, that is the line of it. And here is what you are projecting for us over the next 2 years.

We want to work with you to try to turn the economy around. But speaking for myself, I believe we need faster growth and long-term solutions that will help make us more competitive, not just a few short-term fixes.

And the other thing that concerns me is this idea of trying to have two tax bills. I do not think there is any realism in that, to put together seven fixes to put the honey out there and then not, in effect, realistically pay for them and say we are going to take care of some of these things later on. I just do not think we can do that. And I think it has to be one bill; one package. You have to take all the vinegar along with the honey when you put that package together. We need an immediate plan and a bipartisan plan on an economic recovery plan.

I think that plan has to adhere to the overall limits on the deficit that we agreed to back in 1990. I think that is the discipline that is needed to put together an effective package.

I now yield to the Ranking Republican who is here, my friend, Senator Chafee, for any comment he wants to make.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Well, thank you very much, Mr. Chairman. I appreciate this opportunity to examine the President's budget. I think the top priority we must have is to pass a tax package that encourages economic growth. In other words, focuses on providing more jobs for our people, hopefully without increasing the deficit.

Now, I must say, as we look at this budget for 1993, the deficit is projected to be almost $352 billion, or $1,400 for every man, woman, and child in the country.

And it seems to me this is a terrible legacy to leave our children. Now, it is true while as a percentage of the GNP, the deficit has not risen, the total debt has continued to skyrocket. And, as a matter of fact, the payments and interest on debt in this country in 1993 will be over $300 billion.

And I can remember, Mr. Chairman, and I think you probably can, too, when President Johnson—and that was not so long ago—was reluctant to take the total budget for the country through the $100 billion barrier.

And I think at that time is when he put Social Security on budget, if I am correct, so that he would not break this barrier of the total Federal budget going through $100 billion.

Well, now, 30 years later, we have got an interest component of the budget that is approaching three times that. But we have got a lot of problems here in this country.

As I see it, Mr. Chairman, there are three things we are trying to do. One, we are trying to help Americans retain their jobs or get jobs.

Secondly, we are trying to get it so that Americans can maintain the value of their homes. In other words, that is the real estate component of this package.

And, finally, health insurance. We have got to make sure that Americans can keep their health insurance or control the rising health care costs.

Now, I personally do not believe that these individual tax cuts are going to address this. And this is a subject that I discussed earlier when these gentlemen were here before us last year.

Now, if you ask any American, would you like an additional $500 tax exemption, the answer is, yes, sure. Glad to have it. If you ask any American, however—at least any Rhode Islander—would you like to increase the Federal deficit by $5 billion, which your children are going to have to pay so that you can get 29 cents additional per child per day in reduced taxes, I think the answer clearly would be, no, they are not interested in that.

What they are looking for are jobs, particularly in my section of the country, where we have got all kinds of problems compounded by a constant decline in the defense industries.

So, I think what we have got to do is to have an investment tax credit rather than an investment tax allowance which the administration is suggesting. And I will come to further questions on that when we have the question period after the presentation.

But, for example, the investment tax allowance does not help those small businesses half as much as the investment tax credit.

Now, I know the other side of the coin is the investment tax credit is more expensive. I think we have got to provide some type of relief for capital gains which is provided for in the President's proposal.

I think we have got to have the R&D tax credit made permanent, which they do; the moratorium on the 861 allocation rules continued; and the targeted jobs tax credit, and the exclusion for employee educational assistance.

And, of course, you all know how strongly I feel about the repeal of the luxury tax on boats. So, the thrust, in my opinion, Mr. President—Mr. Chairman, of what we have got to try to achieve——

The CHAIRMAN. That has a nice ring to it, though. [Laughter.]

Senator CHAFEE. Well, I know. But I do not want you to get too used to it. [Laughter.]

You may be called into action the way things are going. [Laughter.]

Well, that is right. And I must say you would be a very, very formidable candidate.

The CHAIRMAN. Let us get back on the subject now.

Senator CHAFEE. I think, just going back a little bit, Senator Dole saying that the problem in the last election was they had the thing reversed. I thought it was a nice compliment to you. I mean, the Democratic ticket reversed, not the results reversed. [Laughter.]

So, there we go, Mr. Chairman. I feel very strongly about supporting the elements of this package that are going to contribute to job growth.

The CHAIRMAN. Let us see. In the order of arrival, I think Senator Breaux is next.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you, Mr. Chairman, and thank our distinguished panel of witnesses whom we are going to hear from today. If everybody is here, Mr. Chairman, I wonder who is watching the Ways and Means Committee. They are acting over there at the same time as we are acting here.

I noticed a chart as we came in, Mr. Chairman, and members—a Consumer Confidence Index Chart. I was thinking that if that was a chart of a patient's health chart in a hospital, they would have to declare the patient dead of cardiac arrest.

It is a real impressive symbol of what the American people are thinking about how we are doing their business. The word I get from my constituents is that things are very, very bad and we need to do something, and they want us to do it very quickly.

And that is a real challenge, and also it raises the possibility of doing the wrong thing. And I think we have to proceed expeditiously, but not rush to judgment on something as important as what we do with the Nation's economy.

There is a great deal of frustration with Congress and with the administration over the state of the economy, and we have a real challenge to face. I think that any package or any proposal that we get is going to have to do something to stimulate growth and investment.

I think a capital gains type of package is something that is essential to do that. I have a bill which we are now currently modifying, which I think others will be joining with me in introducing which I think attempts to break the log-jam on capital gains and addresses the fairness question.

Some in the House have picked it up, I think, and hopefully we can make some progress in that area. I was interested to note that some of the Republicans have apparently come unglued on your capital gains tax proposal, which I do not think is anything different from what has been around for a number of years with regard to the AMT treatment of capital gains. It is not any different from what it has been in the past.

Secondly, I think we can do that by paying a little bit more attention to those students who do not go to college.

I think any proposal needs to help increase the productivity of our work force.

Only one-seventh of the government funds spent on education are spent for training or educating the people who are not going to college, and, yet, over 60 percent of our students do not go on to college.

We have a youth apprenticeship proposal that is pending. I would like to see some type of tax incentives to help employers work with schools, to keep kids in high school by giving them the training that they need to be more productive, and more creative, and more competitive in the work force.

We are doing so much for college-bound students, I think we are neglecting those who are not going to college. And I would like to see some tax incentives in that area.

And, finally, I think that any proposal that is going to be one that meets the real needs are going to have to do something about

energy security. I do not see anything in the President's budget on energy security other than opening up ANWR, which I support, but which is not going to happen.

I think as a start we need some type of AMT, Alternative Minimum Tax relief for independent producers in this country who, if we do not give them the help that they need, are going to quit producing in this country and we are going to become more dependent on foreign imports. More imports hurts the balance of trade and runs up the deficit—we know the problem.

So, I think we need to do something in that area, as well. I look forward to hearing from the panel and engaging in questions. Thank you.

The CHAIRMAN. Thank you.

Senator Riegle.

OPENING STATEMENT OF HON. DONALD W. RIEGLE, JR., A U.S. SENATOR FROM MICHIGAN

Senator RIEGLE. Thank you, Mr. Chairman. I want to say to our three witnesses today that not only from the perspective of what is going on in Michigan and the Upper Mid-west, but throughout the country, including California, where Mr. Boskin comes from, the economy is in very serious trouble. It is in very serious trouble.

And I do not know what it takes to drive the message home in terms of the difficulty that people are facing. And it is essentially a major shortage of jobs, and I mean good jobs.

Now, everybody in this room presumably has a job, and you all have jobs and have incomes. But we have 16 million people in the country today, at a minimum, that do not have jobs, who want to work full-time but cannot find full-time work.

And that problem is not improving. Mr. Chairman, I want to make part of the record, both in the economic report and in the President's formal budget document, on page 37 of the budget itself, as Mr. Darman will, I am sure, indicate today, the administration target for unemployment throughout this year, assuming their entire stimulation plan is passed, is to bring the unemployment rate from 7.1 percent where it is now down to only 6.9 percent.

When I saw this, I actually thought it was a misprint in the document, because I do not think you are keeping faith with the country to develop a plan in the face of this kind of scale of unemployment that actually would purport to make such a tiny reduction in the unemployment across the country.

There was a story the other day from Los Angeles where they had a Job Fair and thousands, and thousands, and thousands of people turned out. They were lined up for blocks. You may have seen it on national television. You should ask your staff to get it and show it to you if you did not see it.

Then we had a scene out of Chicago where there was a hotel being opened, it was sub-zero temperatures, the snow was flying, and there were thousands upon thousands of people lined up there to apply for maybe as few as 2 or 300 jobs.

We have got veterans of Desert Storm who were getting parades a year ago, who are unemployed and homeless now living under bridges and in cardboard boxes. And the plan we are being offered

is to take the unemployment rate down two-tenths of 1 percent, according to your own analysis.

Now, I put a chart up here, because President Bush, when he ran for President, did so on the basis of a pledge that he developed. It did not come from the Congress. It may even have been something that you fellows helped develop.

He said that he was going to undertake a plan to provide 30 million new jobs in America over 8 years. Well, we have now had over 3 years of the 8 years.

And if that pledge were being kept, we would see job growth moving along the line covered by that blue area on that chart. And right now we would have approximately 15 million new jobs in America. But you see here, the real jobs created are shown in the yellow area.

So, there was a little anemic job growth in the beginning, and then that fizzled out. And so we find ourselves now nearly half-way through the time period that he talked about and we have had virtually no net job growth. And that is why you have got this mass unemployment across the country.

Look, let me make it simple for you. We need jobs in America. People need to get up each day and go to work and earn a living to support themselves and their family and the country.

The reason the deficit is sky-high is we do not have enough people working. If people were working and earning an income, they would be paying taxes, as other employed people do, and the deficit would be coming down.

The unemployment is adding to the deficit. It is making it worse. And I think it is just outrageous that people in this country, to have engineers, in some cases, now having to drive taxi cabs just trying to get by, or teachers working in hamburger stands. It is just not right. It is short-changing them and it is short-changing the country in the future.

So, we need a plan here that is much bigger and much stronger. And, you know, I think sometimes if you have a guaranteed income, whether it is a family trust fund income, or whatever kind it is, you can get very detached from these problems. And maybe they can even seem somewhat comic if they are not happening to you or to your family.

I think it would be healthy to visit some unemployment offices and actually talk to the people who are out there. I think the three of you should do it, and I think the President should do it.

These are real people. They may not be members of your family, but they are members of somebody's family and you have an obligation, and this government does, to see to it that they have a chance to work.

And when the Japanese government has a plan so that their people can work, and the Europeans have a plan so that their people can work, we need one in this country. And that does not mean more trickle down.

It does not mean just giving all the money to the wealthy and assuming if they buy more boats over $100,000 that some of it will trickle down to everybody else.

And I would hope, too, if we are going to open up the Tax Code, Mr. Chairman, that we will get some tax fairness. And that means

putting more of the burden up at the top where people have large incomes and giving some tax relief to people down the line who got short-changed through the 1980s.

That is what this country needs. We can get an aggressive jobs program going here; we can get American back on track. Thank you.

The CHAIRMAN. Thank you. Senator Roth, do you have any comments?

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

Senator ROTH. Mr. Chairman, the importance of these hearings cannot be overstated. Important, because Americans are looking for bipartisan leadership from the Congress and the White House.

Our immediate need is to create an environment of growth for American workers, for their families, and their industries; the economic lifeblood of our Nation.

But not only must we meet this immediate need, we must also take this opportune moment to prepare for America's long-term competitive advantage.

Such an agenda must include proposals to increase our National savings rate. It must include proposals to reduce marginal rates and Federal income taxes; and it must encourage risk-taking and business ventures.

This is how America will create a successful economic future. We cannot tax our Nation into prosperity, nor can we create jobs by class warfare.

What we can do is promote an environment of growth, and that can only be done by reducing the ponderous size of government; by reducing needless Federal regulation; by promoting efficiency and self-reliance in an atmosphere marked by a lack of confidence in government.

The people are angry with government. Sixty percent of the people believe Congress is responsible for our economic malaise. Twenty percent would blame the President. In any event, they believe government has helped cause the problem rather than help solve it.

And make no mistake, just as Congress' 1990 record-setting tax increase deepened the recession, further taxes are economic class warfare, and will do to a needed environment of growth what Saddam Hussein did to the environment of the Persian Gulf.

Instead of more and more taxes, what we need are more and more incentives to work, save, and invest. And among the many proposals circulating Congress, there are three that I believe are critical towards creating such incentives.

They include the Bentsen-Roth Super-IRA proposal; an incremental investment tax credit; and a marginal rate reduction in Federal income taxes.

The hallmark of each of these proposals is that they are broad-based, not for one exclusive group over another; they benefit across all segments of our economy and create a large dispersion of incentives for economic growth.

Such a broad-based approach will stimulate our economy universally, not just pockets of our economy where special interests dictate.

Mr. Chairman, many American people are angry with the Japanese. They see Japan as a threat to American jobs and prosperity. They well could be correct, if Congress has not the courage to take steps to create an environment of growth. The United States saves roughly, I think, only 5 to 7 percent, compared with Japanese savings of 17 percent or more.

Those savings enable Japan, with half our population, to invest more in plant facilities and equipment than the United States, thereby, their plants are far more modern, far more productive than ours, and that adds up to a loss of jobs and loss of growth.

The United States must become a savings nation by enacting the Bentsen-Roth Super IRA, which is good for the family and good for the Nation. These savings will enable the United States to invest more in the future, and I urge that the administration throw their support behind this legislation which has been co-sponsored, I would add, by over 75 in the Senate and 260 in the House.

Likewise, I urge the administration to support an incremental investment tax credit that will encourage increased investment in the latest technology, thereby helping meet the challenge of world competition. It is not enough to accelerate such investment for 1 year.

And, finally, any general tax reduction must be broadly based and encourage American people to work, to save, to invest; not just to increase consumption.

A marginal reduction in tax rates will do just that, as well as build confidence in the American people by showing them that they will retain more of their hard-earned dollars.

Mr. Chairman, with this March 20th deadline, the President has provided us with a challenge, and we are here to meet it. And while I cannot agree with all of his proposals, clearly, the President's economic proposals are taking us in the right direction.

I hope the Congress, in a bipartisan manner, can work together with the administration in developing a tax program that will help ensure future growth and encourage the creation of meaningful jobs for all Americans.

The CHAIRMAN. Thank you, Senator. Senator Moynihan, would you care to make a comment?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I would like simply to welcome our distinguished friends and to say, just by way of comment in a bipartisan manner, that it was particularly welcome to see in the President's budget that he proposes to restore the fair-market value deduction for gifts of appreciated property, including securities to universities and colleges, and artworks, to museums. It is something we need to fix, and obviously will do.

And, also, to thank whoever was the guardian angel who looked after the tax treatment of transit benefits to employees, so that employees will not owe tax on the value of mass transit benefits provided by their employers. We are trying, in keeping with our Sur-

face Transportation Act, which was a large enterprise last year, to get a fair and productive balance between automobiles and transit.

We have a situation where parking benefits, however generous, are tax-free, but transit benefits above $21 per month are taxed. And now this proposal to increase the monthly tax-free amount from $21 to $60 may seem a small thing, but over a period of time it changes patterns effectively, and I would like to thank you all for doing that.

The CHAIRMAN. Thank you. Mr. Secretary, if you would please lead off.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman and members of the committee. I am pleased to testify today on the economic proposals announced by the President in his State of the Union address.

The President's actions and proposals will accelerate economic recovery in the short-term, stimulate the Nation's long-term economic growth, and increase the competitiveness of American goods and services in the world economy.

The President's comprehensive program for growth includes initiatives beyond those we shall discuss here today. For example, record Federal investment in research and development in Head Start, and in children generally; in education; crime and drug abuse; and in preventative health.

The President's program for Job Training 2000 will improve the delivery and effectiveness of job training and vocational education and his proposal to combine law enforcement and social services is designed to reinvigorate impoverished and embattled communities.

When enacted by the Congress, the President's plan will expand opportunity and enhance the nation's standard of living. The President's tax proposals are specifically addressed to the fundamental economic concerns of American families.

As you know, Mr. Chairman, many factors have coalesced to make the economic recovery sluggish. We experienced a Mideast crisis and a war, during which oil prices rose to over $40 a barrel. We have had 2½ years of restrictive high interest rates that only recently have come down.

The nation's businesses and its families and government have borrowed too much, and, unfortunately, improving the climate for increased jobs and investment has not been a Congressional priority.

Nevertheless, there are some encouraging signs. American corporations and families have moved to pay down their debt burden. The spiral of rising prices has been halted so that American families need no longer fear that runaway inflation will rob them of their purchasing power.

And American businesses do not have to worry that rapid price increases will render American products non-competitive in world markets. American exports are strong, and business inventories are lean.

Interest rates are now the lowest in 20 years. The decline in interest rates could, in 1992, save American families as much as $25 billion in interest costs on mortgages and other household debt.

Low interest rates also should mean a savings of about $10 billion for American corporations, and Federal, State, and local governments will save another $10 billion because of these lowered interest rates.

And all of this has occurred against the back-drop of the end of the Cold War, an economic stimulus that none of us can now calculate, but which will be, over time, of enormous proportions.

But positive signals are only the beginning. The American people remain concerned about the strength of their nation's economy. People who have worked in industries or companies that have contracted want to be confident that they can find new jobs, and, if necessary, shift careers.

Families who own no home want to be sure they will someday, and homeowners hope to see strength in the value of their house; their most valuable asset.

American families deserve to be confident about their children's future, the quality and safety of their children's schools, and their ability to afford the education necessary to raise their children and grandchildren's standard of living.

The public is entitled to assurance about the soundness of the financial institutions on which they have long depended for help and security. Witnessing the failure of a savings and loan or bank where you or your neighbors have saved and banked is an unsettling event.

The country worries that American banks, which for so long were dominant in the world, are now overshadowed by foreign banks. Small businesses and other investors have had difficulty obtaining loans they need to expand their businesses in order to create jobs.

And the Congress so far has refused to modernize the legal framework governing banks that was designed decades ago for a totally different economic era.

The American people deserve to be certain of our ability to compete in the new global economy. They demand that we maintain our advantage of superior technology and our capacity for stunning innovation.

Mr. Chairman, there is only one response that we, the Congress, and the President working together, can make to fulfill the hopes of the American people.

We should embrace policies that foster economic growth. We should move at once to enact into law the President's proposals that will accelerate economic activity and the recovery.

We must demonstrate an unwavering commitment to creating an environment for sustaining growth over the long term with a consequent increase of paying jobs.

Over time, gains in family income depend on improved national productivity. Only sustained economic growth can improve the incomes of wage-earning men and women.

Only sustained economic growth will provide the resources to feed and house the poor, and guarantee health to all Americans. And only sustained economic growth, not higher tax rates, will increase the resources of Federal, State, and local governments.

There should be no misunderstanding about this important point. A 1-percent decrease in real GDP growth in 1992 alone could decrease Federal Government receipts by nearly $80 billion and in-

crease the Federal deficit by more than $100 billion during the period of 1992–1997.

A 1-percent lower annual GDP growth rate during each of the years from 1992 to 1997 would decrease the Federal Government's receipts by more than $260 billion, and increase the deficit by nearly $350 billion during that period.

It is pretty clear that the productive power of economic growth as a contributing to government revenues is not a controversial theory.

If the collapse of Communism and the disintegration of the Soviet Union this past year have taught us anything at all, it is that government policies that concentrate on managing how limited resources are distributed among the people are a poor substitute for concentrating on ensuring economic growth.

The President's economic growth agenda will accelerate economic recovery and job-creating investments, create opportunities for home ownership, foster a real estate recovery, and help families build for the future. The economic growth agenda set forth by the President is simply about one thing: jobs.

The plan calls for a new investment tax allowance, which could produce nearly $11 billion of tax savings in calendar 1992 for businesses that acquire new equipment, thereby increasing their cash flow, lowering their cost of capital, and putting more jobs on the line.

The President also recommends permanent adjustments to simplify and liberalize the Alternative Minimum Tax to remove tax impediments for modernizing business plant and equipment.

Both of these measures will provide manufacturers strong incentives to create new jobs and to create them now.

Jobs and global competitiveness also demand that businesses carry on vigorous research and development. The President's plan would make permanent the credit for research and development and extend the rules for allocating R&D expenses to foreign and domestic income.

Although it is the largest economy in the world, the United States continues to be the largest investor in R&D activities. The rate of growth of non-defense R&D has recently been much higher in West Germany and Japan; not a good trend.

The President has increased funding for basic research by 29 percent since 1989, and continues to recommend record levels of Federal funding for R&D. Each year since taking office, the President has proposed making the R&D tax credit permanent. This is the year to act.

The President has also urged Congress to cut the capital gains tax rate, which will raise American living standards by unlocking job-creating investments, boosting productivity, and raising the value of productive assets.

The President has proposed cutting the capital gains tax to 15.4 percent for taxpayers now subject to a 28 percent capital gains tax rate, and to 8.25 percent for taxpayers now subject to a 15 percent capital gains rate.

Reducing the capital gains tax will be particularly helpful to America's new companies and small businesses in attracting start-up capital. These small businesses and start-up companies tra-

ditionally rely on equity capital. They cannot float bonds, they cannot issue commercial paper, and they cannot compete with big corporate rivals for bank loans. At the same time, these firms continue to be the source of new jobs.

The statistics are clear: businesses with 20 or fewer employees generate over two-thirds of all net new private-sector jobs.

Lowing the capital gains tax to create jobs and make America more productive is a bipartisan objective. At least 200 Democratic Members of Congress—more than two-thirds—have sponsored or co-sponsored legislation to reduce the capital gains tax.

The argument is really about what kind of capital gains tax to have. The President's proposals is broad in scope. It would reduce the burden of over-taxation of inflationary gains for all Americans.

It would benefit the larger number of middle-income people who realize capital gains and would unlock capital for more productive uses. A targeted capital gains tax cut could not serve each of these important purposes.

The President's economic growth plan also recognizes the importance of a healthy real estate sector in our economy and the critical need to ensure that businesses have access to credit.

Real estate and construction represents more than 15 percent of our Gross Domestic Product and employs almost 10 million people. More than half of all household net worth is in real estate.

That is why—in addition to our ongoing efforts to keep interest rates down and increase credit availability—the President has asked for a $5,000 tax credit for first-time home buyers, modification of passive loss rules for real estate developers, opportunities for greater pension fund investment in real estate, deductibility of losses on the sale of personal residences, and an extension of the mortgage revenue bond authority.

The President also proposes tax incentives for enterprise zones to stimulate jobs and investment in disadvantaged rural and urban areas, and the extension of both the targeted jobs tax credit and the low-income housing tax credit.

The President's plan will both hasten economic recovery and help American families with proposals that specifically address their most pressing concerns.

These family concerns include an increase in the personal exemption for families with children; and a new flexible IRA that will allow families to begin saving, regardless of purpose, without any income tax burden.

In combination with the other proposals I have mentioned, the President's $5,000 tax credit for first-time home buyers will help middle-income families purchase their own homes, and offer protection to current homeowners from declining property values.

In combination with the President's proposal to increase funding for Head Start by $600 million and the administration's other education initiatives, the proposals to permit deduction of interest on qualifying student loans and penalty-free IRA withdrawals will help families fulfill their educational goals.

The President's health plan, which he presented last week, builds on the strengths of the existing market-based system. It will provide tax credits or deductions for the purchase of health insur-

ance of up to $3,750 for poor and middle-class families. This will provide financial help for more than 90 million people.

These initiatives will provide stimulus in both the short and the long term. They will make it possible for American families to buy homes, save for college, guard against major health expenses, and plan for retirement.

The President's plan is directed at the specific needs and aspirations of Americans. For families attempting to buy a home, save for the future, finance educational loans, or purchase health insurance, his plan provides substantial tax savings.

Issues of American justice arise in many contexts, but there can be no doubt that among them is the requirement that burdens and benefits of government must be fairly distributed.

The President's plan meets this test of fairness. The current distribution of taxes and transfers is fair, despite widespread claims to the contrary.

As Graph 4 to my testimony shows, the net effect of Federal tax and transfer programs is highly progressive. In 1990, households in the top 20 percent paid an average of over $22,000 to the Federal Government, while households in the lowest 20 percent received an average of almost $8,800 from the Federal Government.

But I do not wish to dwell on statistics. They can be shown to prove almost anything. For example, tax distribution tables depict only the burden of payroll taxes and leave out entirely the payment of Social Security and Federal health insurance benefits.

These social insurance programs, which are highly progressive, should be included in any fairness chart, and they are not. Comparisons of the tax burden alone without the benefits presents a very distorted picture.

However, even if viewed by itself, the Federal income tax is also progressive. The President's plan for economic growth is fair. The full array of the President's plan, including the health plan, would dramatically decrease taxes for low- and middle-income families and would only slightly reduce taxes for those with higher incomes.

The President's program to accelerate the economy, provide jobs, and improve the climate for long-term growth is accomplished while maintaining the fiscal restraint of pay-as-you-go.

We cannot achieve economic growth if Federal spending is not controlled. Confident, stable financial markets live in the house of financial discipline, and interest rates and long-term growth depend on adherence to this important principle.

Creating an environment through this Nation's tax spending and regulatory policies that invites and sustains long-term growth is no simple task. There is not any silver bullet. However, we now have an opportunity to put in place some important building blocks.

The President in his State of the Union address required Congressional action by March 20th on seven proposals: capital gains; investment tax allowance; the AMT changes; easing of passive loss; the $5,000 credit for home buyers; the waiver of penalties on IRA withdrawals for first-time home buyers; and proposals which will make it easier for pension funds to help purchase real estate.

These proposals should be enacted immediately to accelerate the economic recovery. The total cost of these proposals over the fiscal year 1992–1997 is just over $6.6 billion.

The President's budget provides a variety of ways to cover this cost in a manner consistent with pay-as-you-go discipline. There is simply no reason why the President's economic growth proposals should not be financed through reductions in Federal spending.

The President would prefer prompt enactment of all of his program, but surely these few changes can be enacted now. It should be done promptly and it must be paid for.

In conclusion, this Nation remains the world's preeminent economic force. The United States is the world's largest exporter of goods and services, and the world's largest foreign investor.

No one should underestimate the energy and optimism of the American people, nor the resilience and fundamental strengths of the American economy.

The government alone cannot make American products more competitive, but, in partnership, the President, the Congress, American businesses and workers can construct an environment to facilitate the nation's productive growth.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Secretary.

[The prepared statement of Secretary Brady appears in the appendix.]

The CHAIRMAN. Mr. Darman, if you would proceed, please.

STATEMENT OF HON. RICHARD G. DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DARMAN. Thank you very much, Mr. Chairman. Chairman Bentsen, Senators Roth and Chafee, Senator Moynihan, Senator Riegle, Senator Breaux, it is a pleasure to appear before you once again.

Mr. Chairman, I have—and I believe there are copies before each of you—submitted for the record, with your permission, a copy of the introduction to the President's budget, which I ask be included as my prepared statement.

The CHAIRMAN. That will be done.

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

Mr. DARMAN. Thank you, Mr. Chairman.

Because that statement is familiar to all of you now, and because Secretary Brady has offered a comprehensive introduction, I would propose to save time and allow more opportunity for us to try to respond to questions by just making two or three very brief observations.

First, as Secretary Brady has well-outlined, the President has proposed a comprehensive plan for both the short and the long run. Second, we believe that it is entirely reasonable to ask for action by March 20th.

Third, noting the chart that is displayed concerning consumer confidence, and which reflects a very troubling pattern, I know we all agree that we would like to see that line turn up quickly. There is quite a bit of disagreement, perhaps, as to exactly what it takes to turn that line back up sharply.

My personal view is that in addition to whatever is required economically, it would be helpful if the public could see that its institutions of government, faced with an obvious challenge, could rise

to it and get the job done properly and promptly. That is obviously just a personal judgment.

In any case, with that in mind, and for a host of other reasons, I appreciate your expression at the outset, Mr. Chairman, of an interest in working with the administration. We, too, look forward to working with you and this committee. Thank you very much for the opportunity to be here, and we will try to respond to your questions.

The CHAIRMAN. Thank you.

Mr. Boskin.

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS, WASHINGTON, DC

Mr. BOSKIN. Thank you, Mr. Chairman. Likewise, Mr. Chairman, with your permission, I would ask that my full statement be entered into the record.

The CHAIRMAN. That will be done.

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

Mr. BOSKIN. I will just make two or three observations. First, following up on Secretary Brady's statement, I think it is helpful to divide the economy's problems into a set of short-term cyclical and structural problems and a long-term productivity growth problem.

Although I do not mean to divert attention from serious short-term challenges such as unemployment, sluggish growth, et cetera, it is worth noting that while America has the highest level of productivity of any advanced economy—about a quarter higher than Germany and Japan—our productivity growth rates for the last two decades have been much slower.

Unless we raise our rate of productivity growth, it will be difficult for America to maintain its leadership role in the world economy and to provide American citizens with what they expect: higher standards of living; abundant employment opportunities; and substantial economic mobility.

The President's agenda includes things that we believe would be very good for productivity growth over the long run, but are not often thought of as fiscal policy or even economic policy, such as education reform and civil justice reform. We believe these reforms will be good for the American economy over the long term by helping to make our workers more productive.

Let me spend just a minute on where the economy is, what it has gone through in the last year, and our projections.

Obviously, the economy entered a recession in the latter part of 1990. Real GDP collapsed relative to modest growth, declining in 1990's fourth quarter, and first quarter of 1991; then growing in the second and third quarter.

Back when we were making last year's economic outlook and forecast for the budget in December 1990 and early January, we were still in Desert Shield, not even Desert Storm. An overwhelming majority of private analysts, the CBO, the Federal Reserve, as well as the administration, expected the modest recovery that appeared to begin in the spring of 1991 to continue as the year progressed.

We are about at the same place as the blue chip average; a little less optimistic than the CBO on that score. But, obviously, from

late summer until today the economy has flattened out. It is flat, sluggish, and struggling. Growth was essentially flat in the fourth quarter.

Those data will get revised quite a bit. We expect growth to be slight in the first quarter. We do expect the economy to begin to improve as we move through the year, but, again, at a very modest pace.

We think the President's program, or something close to it that has the same economic effect, would not only speed and strengthen that recovery, but would make it more certain.

Economic forecasting, as I always tell this committee, Mr. Chairman, and other members, is an imprecise science. Virtually none of the private-sector forecasters, the CBO, the Federal Reserve, or the administration forecasted the flattening out of the economy at the end of the year.

And while we were more accurate than all but eight of the 52 private blue chip forecasters, virtually none of us forecasted this. So, we cannot be certain we will have a modest recovery. The economy has ample room to do better, and obviously we would hope that it would do better.

But there is also no guarantee it will grow at a 2.2 percent pace. There are things that could cause the economy to do better or do worse, and it would be wise to bear all those in mind.

In addition to the high interest rates and the oil shock that Secretary Brady spoke of, which economists traditionally think of as short-term cyclical hits to the economy, we have structural imbalances: the credit crunch, problems in real estate, the shift in defense spending from considerable expansion during the late 1980's, to current prospects of substantial downsizing; and the higher debt burdens of households and corporations relative to income and profits. The working off of all of these imbalances is the major reason why we expect the recovery to be more muted than the past average.

The chart, as you noted, excludes the 1980 to 1981 period and would look a little different if it was included.

How fast the economy works through these imbalances will have a lot to do with how strong the recovery is when it occurs, when it accelerates, and what sort of a headwind the economy is forced to grow into.

But these are problems the economy has to address, some of which are amenable to public policy and economic policy. We have made proposals in these areas we believe are responsible.

Finally, I would like to add one economic point and one quick statement with respect to some comments that were made in the introductory remarks of the committee.

All the industrialized countries of the world have had serious economic problems in the last year or so; some for the last 2 years.

If we look at the G–7 countries, several entered recession prior to the beginning of the U.S. recession and had much deeper recessions.

Others are on the verge of, or are in recession now. Even the ones that are doing the best among the seven have experienced a sharp slow down in current growth relative to 1990 or early 1991.

That suggests that, while we have serious problems in our economy and we have serious problems that are internal to the American economy, there are some factors that have caused all of these countries to experience problems.

I would like to add two points for the record to clarify a couple of things. While I agree with much of what many of the members said, I would like to clarify that unemployment in Europe is, on average, substantially above that in the United States.

That is no reason to be complacent; we have a serious unemployment problem in the United States. But I think it is important to clarify that a problem exists in Europe as well. It is also important to clarify that although we have a very serious deficit problem, only a relatively modest part of the projected deficit—about one-seventh of the projected deficit for 1993—is the cyclical component. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Secretary, I could not help but think that no one should underestimate the optimism of the American people. That is where it is. It is the lowest it has been since 1980. [Pointing to a chart.] That is what they think they are getting out of politics that they are undergoing in the country today. That is what we have to turn around.

Let me visit with you a little bit about this two bill strategy and see what the administration is talking about and my deep concern about it. I am really surprised that the administration would cut down and slim down a bill to make the centerpiece of it be a capital gains cut in taxes that benefits the wealthiest Americans.

Let me quote the Washington Post this morning, and what it says a Congressional Republican says. It says, "The White house really never wanted anything but the narrow package." The tax package. "The President outlined the broader one to have something for the middle class and others to compete with the Democrats." The White House needed a campaign speech.

Well, I have seen that two bill strategy tried before. And my experience is you never see the second bill. Does the White House really expect the Congress to support a bill giving tax cuts to high income individuals and put off income tax relief for working Americans until the second bill?

Secretary BRADY. Well, Senator Bentsen, I saw you point to the chart on consumer confidence and I assume that you join with me in having a basic confidence in the optimism of the American people; I know I certainly do.

And the fact that it waivers from time to time should not, in my opinion, stop us from having confidence that Americans, if given the chance, will get the job done.

So, the optimism and confidence figures go up and down, but I truly believe in the basic strength of this economy and its ability, if the American people are given the chance, to get things accomplished and jobs put on the line.

Let me now turn to the bill that is suggested and put before Congress by Representatives Michel and Archer, which backed up the President's call in his State of the Union for action on seven items. I think the wisdom of having put that proposition forward in the State of the Union is being borne out. What I see out of this process is an ability not to act on the things that he has asked for.

So, I would disagree. I have great respect for you, but I hope you will give me the credit for having been present when the President put his package together.

And his package is a document that he believes strongly in, and one that I am sure, if enacted, would make a big difference to this country. So, with all due respect, we just have a difference of opinion.

The CHAIRMAN. Well, Mr. Secretary, if this Congress would pass legislation that enacts a tax cut on capital gains, would you recommend a veto of it if it was partially paid for by a tax on the highest incomes in the country?

Secretary BRADY. Well, Senator Bentsen, let me say first of all that the idea that you create a stimulus by cutting the capital gains tax is quite clearly in one part of an economic recovery program. Others, using some misguided theory suggest that it has to be turned around and deducted from, and would institute a tax increase. This does not make any sense.

The CHAIRMAN. Well, let us get into that one a little.

Secretary BRADY. Could I just finish one second, sir?

The CHAIRMAN. All right.

Secretary BRADY. My belief is that economic stimuli are not a zero sum game. There is no point in creating a stimulus on the one hand, and then on the other hand say, increase income tax rates in the middle of a sluggish economy. It just does not seem to me to make any sense.

The CHAIRMAN. Well, let us look at what Treasury said in 1986. In 1986, the Treasury estimated that an increase in the capital gains rate would increase revenue. You are now telling us that a decrease in the tax rate will also increase revenue. Now, you just cannot have it both ways. How do you explain those conflicting statements?

Secretary BRADY. Well, I would say, Senator, the circumstances were different at that particular point in time. We stand by the estimates that are made now.

We think a decrease in the capital gains rate would create economic opportunity for everybody and we have had this fairness discussion for a long time. I stand by my statement that there is nothing more unfair than a guy without a job.

The CHAIRMAN. I defer to the Ranking Minority Member here, Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. In my opening remarks, I made reference to my concern about the savings rate of this Nation, which is far lower than that of the Japanese, as well as other industrial countries.

We have an IRA that is being sponsored by the Chairman and myself that has the support of over 75 in the Senate, and I think something like 250 in the House. Obviously, savings are important if we are going to meet the competitive threat from abroad.

We have an opportunity here to do something. The administration has taken some good steps from the standpoint of flexibility. But I would hope that the administration would support the enactment of this legislation, which can have a significant impact on the individual savings rate of this Nation.

It is a program that is not only good for the nation because it increases savings, but it is good for the family. And while I do not expect you to reverse ground at the present moment, I would hope, Mr. Brady, and you, Mr. Darman, as well, Mr. Boskin—we discussed this recently in the Joint Economic Committee—would review this, because this is an idea whose time has come.

The votes are there, and it is important that we have the support of the administration. Would you care to comment, Mr. Brady?

Secretary BRADY. Well, we certainly agree with the sentiments and philosophy behind your and Senator Bentsen's IRA proposal. It attacks an absolutely essential problem, which is savings.

I would say that it is a little bit mystifying how we can talk about savings in this category and not the benefits of IRA's, which confer greater benefits for the wealthiest parts of the income distribution. I totally agree with both of you gentlemen that IRA's do generate new savings that increases jobs. However, in the capital gains tax debate, the same income distribution points are cited as the reason for not going forward. So, I call attention to that anomaly.

Senator ROTH. I would point out, Mr. Secretary, that I have not been adverse to your capital gains proposal, so——

Secretary BRADY. I understand that. I just say that I think the theory behind your and Senator Bentsen's proposal is a very good one.

It is the same theory that is behind the capital gains, which is savings and investment incentives will put more jobs on the line in this country, and we are all talking about jobs.

So, I think, Senator Bentsen, and Senator Roth, my hat is off to you. You realize we have a slightly different proposal ourselves, but the import is the same exact theory: increasing savings improves the climate for job creation.

Senator ROTH. Well, as I said, I would hope that this would be reviewed in the White House. We all talk about savings. Studies have shown that the IRA did increase savings in the 1980's. We have had witnesses before us showing that and it is time we quit talking about doing something about individual savings and begin to act.

I am also concerned about the comparison in investment of new equipment and facilities in comparing Japan and ourselves. Japan, with a GDP half of ours, with half as many people, are investing more—something like, I think, $650 billion to our $525.

Now, that means that in the long term, their facilities are going to be more productive; that they are going to incorporate the latest technology on a higher level than that of the United States.

So, my question is, what are we going to do about that? I understand your acceleration of depreciation and the benefit that that may have in the first year, but somehow we have to invest more in new equipment.

I have proposed that we have an incremental investment tax credit that would reward those who invest more than they have in the past. It would be particularly helpful to smaller businesses, and that is where jobs are created at a faster rate. Would you comment?

Secretary BRADY. Well, I think we agree, Senator Roth. You have said it very clearly and explicitly, and the President's program, I think, enacts a great many of the things you have talked about. We agree.

Senator ROTH. My only comment, Mr. Chairman, is I agree that the White House has sought to address them. I do not think they go far enough. I think that is the problem, and I would hope that we could work together in trying to develop the kind of programs that will meet the need.

The CHAIRMAN. Thank you. In the order of arrival. Senator Breaux, if you would.

Senator BREAUX. Thank you, Mr. Chairman. Thank you, members of the panel. Let us talk about a capital gains tax cut, to start with. We all know what the two biggest problems have been to enacting a capital gains reduction. First, some say it only benefits the rich. Second, is the question of whether a cut raises or loses revenue.

Well, of course, wealthier people have the largest capital gains; they invest in larger investments. But the facts, I think, also show us that about 60 percent or more of the people who have capital gains taxes in this country are people that make less than $50,000.

My father never made $50,000 a year in his life, but had capital gains because every month he bought stock in the company that he worked for.

He would probably like to sell some of it for his retirement, but does not want to do it because we have the highest capital gains tax rate in any industrialized country in the world.

So, I think the wealthy argument has to be addressed. If we do not get past that, you are never going to pass it in Congress.

The second argument against it is we do not know what it is going to do. I mean, Treasury tells us it is going to raise $12 billion. Joint Tax tells us it is going to lose $12 billion. So, all of us in Congress say, what in the world are we going to do? We do not know what is going to happen if we pass it.

I have introduced a capital gains tax reduction bill, cutting rates to 25, 22, and 20 percent, based on being held 3 years, 2 years, and 1 year.

And I try and address the problem of not knowing what it is going to do by saying, let us do it, and then have a safety net of protection in the out years that if the capital gains tax cut actually raises revenue, we all are winners. Everybody should be happy. We have created more jobs, and more people are working, more people are paying taxes. But if it loses revenues like some analysts tell us, then we have a fourth tax rate that could be kicked in to pay for it so that we do not burden the middle-income people in this country.

The fourth tax rate would never go into effect if it raises revenues. But we protect middle-income and working people in this country in case it does not work.

Now, we are making some adjustments to that, because it does not have to be 36 percent if the need for revenue is less. It could be less. We are going to make a system that goes into effect and poses a different rate, depending on how much we need to make up for the loss, if there is a loss.

We are working on a baseline, which is a neutral baseline; a fair baseline from which to judge whether it works or whether it does not work. Now I would like to have the comments of the administration on that type of a proposal.

Secretary BRADY. Well, Senator Breaux, I think first of all your proposal is a serious proposal. It is based on a lot of hard thinking on your part, and I salute you for having addressed the basic problem of trying to come forward with a capital gains proposal that will work.

It has some technical difficulties connected with it: Who determines the baseline? How do we arrive at the baseline? Is it done on OMB or CBO scoring?

We would not agree that a tax increase ought to be a part of it, but if you did, whom do you tax? If you introduce a higher tax rate of 35 percent, how do you differentiate between some guy that had a capital gains and some guy that did not? So, I think it has some technical difficulties.

And some people who have been working on your proposal, I know, feel that it might have more appeal if the conclusion were not the institution of a higher tax rate, but just that if the revenues did not show up, that the capital gains tax differential was then stopped.

So, I know there are many people working on this. I salute the basic theory and philosophy behind it. But, at this particular point in time, we think the President's plan would be a better one.

Senator BREAUX. But it is not going to pass. I mean, I am trying to find something practical——

Secretary BRADY. Well, let us get a vote on it, then we can find out.

Senator BREAUX. Well, we have had votes on the thing. And the two points I am outlining as the problems are there and they are not being addressed.

I mean, people say it only benefits the rich, and we have not solved that problem. And people do not know whether it is going to gain revenue or lose revenues. Under your suggestion, if we lose revenue we just chalk up the loss to the deficit and we do not pay for it.

Secretary BRADY. I did not say that.

Senator BREAUX. Well, what you said is you stop it at that point, but you do not pay for what has been lost up to that point.

Secretary BRADY. But I do not want to get into the details of this, but your proposal said that if it did not raise the revenues that it was said to have raised, then we would stop it. I say suppose it was neutral. Then why should you institute a new tax?

Senator BREAUX. Well, if it neutral, Mr. Secretary, there is no tax increase. The only time the fourth rate would go into effect is if there is a loss and the tax rate is to pay for the loss.

Secretary BRADY. Well, I understand. But the problem is there are a lot of technical difficulties with this thing which we would be glad to work on with you. But there are 220 Democratic members of Congress who have got capital gains proposals out there, so I think if you would give us a fair vote on this thing, it would pass.

Senator BREAUX. Well, what about energy? The only thing I see on energy in the budget proposals is ANWR. The AMT tax on inde-

pendent producers in this country, which account for most of the production, I think is killing them financially and we are losing a whole entire base of companies that produce energy for this country. We are importing 45 to 50 percent of our energy.

What about AMT type of relief for independent producers?

Secretary BRADY. Well, we think there are some proposals in here, such as the capital gains tax, that would help energy producers.

Senator BREAUX. Not if it is not offset by Alternative Minimum Tax. It does not help them at all.

Secretary BRADY. Well, certainly in other industries it is offset. It just is not completely offset at this particular point in time. Nonetheless, it would make a big difference.

But we would be glad to look with you at any ideas you might have in the idea of promoting energy production, because the President feels very strongly that having the search for energy go on abroad, where the oil and gas that is found and winds up in foreign hands, is not in our interests. So, we would be glad to look at anything you might want to talk to us about, Senator.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. I would ask that this chart be put back up. I think, Chairman Bentsen, in going over earlier to the consumer confidence chart, really illustrates the problem.

And that is, the people of America, based on what is happening to them—what they see going on in their own lives, the people around them, and in their communities—they feel that we are losing our economic future. It is not just the recession; that is the short-term problem. It is the underlying long-term problem and the loss of good jobs throughout our society.

We see United Technologies announcing 14,000 jobs being eliminated; General Motors, 74,000 jobs; IBM, several thousand jobs; AT&T; it is a list that cuts right across the board. And it is not just large companies, it is medium and small-sized companies as well.

And it is clear, I think, to the American people that we really need an aggressive economic plan for America.

I mean, we need a big, strong, muscular plan to drive this economy, and it is one where I think business, and government, and labor need to sit down around a table together and work out the plan so that there are enough good jobs around; that we are planning our future to make sure that there is enough work for our people, both in terms of personal income, and national income.

And that means high value-added jobs. It does not just mean whatever happens, but it means aiming for and getting the high technology, high value-added jobs.

Now, I would like to ask all of you. I want to come back to the President's promise that he made when he first ran for the Presidency. And he set this goal—and I assume one or more of you were involved in those discussions.

I do not know why he picked 30 million jobs as his goal over an 8-year period of time, but obviously he was relying on input from yourselves or others like you.

And now we are nearly half-way through that, and we should be up at the top of this line. Right now we ought to be up at this par-

ticular range up in here, and we are down at the bottom. So, all of these jobs that were to have been created according to his goal just have not materialized.

Here is the thing that bothers me. You come in with a plan, and, according to your own budget documents, you are going to take the unemployment level this year—if your plan is enacted in every detail—down from 7.1 percent—the highest it has been now for a long time—a very tiny amount to 6.9 percent throughout this entire year. I mean, that is what your figures show in your chart.

Now, my question is this: why should we not enact a plan right now that takes us from down here at the zero level in terms of net job growth and shoot to get right up to his goal?

Why should the plan not be scaled to keep this objective? Now, you clearly are not giving us a plan like that, and I want to know why. Why should we not right now agree on crafting a plan that is going to close that job gap and give us the number of jobs that the President says we need?

Mr. Boskin, why should we not do that? Should that not be our goal?

Mr. BOSKIN. Well, the goal, obviously, should be to create the best possible climate for economic growth and job creation. Obviously, events that have ensued—many of them inherited from the past—have caused the economy to be much more sluggish than expected. We have had to work through a variety of problems that have made it very difficult to add as many jobs as we would have liked to have seen added, and I am sure you would have liked to have seen added.

If there was a program that I knew of that could do what you just asked, I would have recommended proposing it. But we believe——

Senator RIEGLE. But what did he have in mind in the beginning when he set this out?

Mr. BOSKIN. We believe that a variety of the things the President has laid out will be good for employment growth; will increase productivity and wages; and will improve the economy.

When you look at what has happened to the economy over the last couple of years, there is a fair amount of credit and a fair amount of blame to spread around.

The President has had proposals the Congress has not enacted. The Federal Reserve has had a monetary policy which certainly, in retrospect, was too tight for too long. We did not anticipate an oil shock and a war. And I could go through a variety of other things.

Senator RIEGLE. Well, let me ask you this. I appreciate that. But you are in here now, looking from today forward, with a plan to try to fix the problem.

And you have laid out the plan, and, according to your analysis, the plan essentially leaves unemployment the rest of this year just about where it is.

Mr. BOSKIN. Well, it declined slightly.

Senator RIEGLE. Yes, it declined. But——

Mr. BOSKIN. Not as much as we would like, but it will create about 1.7 million jobs by the end of the year.

Senator RIEGLE. But if you have got 16 million people out there that need full-time work and are not getting it, why are you not

setting a higher goal? I mean, why are you not coming in with a plan that creates more jobs faster? I do not understand it.

Mr. BOSKIN. We are trying to be realistic, Senator. The economy has problems, and I do not think it would be wise for anybody, in either branch of government, to be suggesting to the American people that there are magic silver bullets that can cure the economic problems that have been inherited and have been created—some of which are worldwide—overnight.

Senator RIEGLE. Well, we are not talking about overnight.

Mr. BOSKIN. So, it is an attempt to be——

Senator RIEGLE. We are talking about through the rest of the year.

Mr. BOSKIN. It is an attempt to be realistic about what can be accomplished. There are a variety of proposals that have been put forward by others, yourself included; some components of which I think are wise and we agree with.

But I do believe that we start, for example, with a large inherited budget deficit problem that Senator Bentsen outlined early on, and it is obviously much riskier to embark on a massive fiscal stimulus that may wind up undoing the good that is in the pipeline from lower interest rates.

Senator RIEGLE. Well, I know my time is up. But I will just finish by saying in effect what that says is that the unemployed then, you really have no answer for most of them.

We simply say to them, in effect, "sorry, we really cannot help you; things are beyond our control. And even though we thought at the outset we could provide enough jobs for you, we just cannot do it."

So, you are just going to have to bide your time. I mean, that is the bottom line of what that strategy says. And I do not think you can say that. I do not think you can say it in conscience, and I do not think it is good economics.

Mr. BOSKIN. Well, you are certainly entitled to your opinion. I believe that we are laying out a program that, if passed, is the best possible program to speed the creation of jobs and make sure that the long-term problems of the economy are also addressed.

So as we look to the future, we seek not only to re-employ as many Americans as possible through the balance of this year, but we also seek to create a foundation that will increase productivity growth and, hence, maximum wage growth over the careers of American workers.

The CHAIRMAN. Thank you, gentlemen. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. I have tried to think of what your problems are from your point of view, and, as you said, Dr. Boskin, to be realistic about what can be accomplished.

And if I could enter your situation, I guess it is that tension you have between an extraordinary deficit, a budget in which for the first time debt service will be the largest item, and the question of whether a Keynesian stimulus action makes any sense in the face of such deficits; would it have any effect?

Because you are taking so much money out of the economy, what little you put back in is insignificant. Nevertheless, last December, the President signed the largest public works legislation in history.

It was a bill very much responsive to concerns that you have had, for example, about productivity in transportation, which is running at a medieval rate: 0.02 percent, as the administration told us.

We responded with a bill that said we are going to talk productivity; we are going to talk investment; we are going to talk cost; we are going to talk accountability.

And the President, in the State of the Union message, said that bill creates jobs, jobs, jobs. It will create wealth.

The President said this on a Tuesday night at the State of the Union, and the next morning he sent us his budget in which he reduces the amount of spending for transportation by $4 billion. Even though there are trust funds set aside for this purpose. I mean, those are the jobs right there in front of you; investment right there in front of you.

Mr. Secretary, is this another trust fund we are beginning to hold back as a deficit restraint as we are doing with Social Security? This year on Social Security you are going to be taking $65 billion of Social Security surplus and using it as general revenue.

I mean, wouldn't the spending called for in the Surface Transportation Act create jobs? I mean, I like your phrase. What did you say? That there is nothing more unfair than a guy without a job. Well, there was a bill. We worked together with the administration. The President signed it, said it was great, and then the next morning he said he will not fund it. You are going to pass that one to Darman, are you?

Secretary BRADY. He is the architect of the transportation bill.

Mr. BOSKIN. Darman and Skinner are on our side, Moynihan is on the Senate side.

Mr. DARMAN. Senator, a couple of points. One, as you know—although I know you do not agree with the wisdom of this—there is a law which puts a cap on the overall amount of domestic discretionary spending in both budget authority and outlays, and you have to meet both caps.

Our budget is at the cap and we do not have any room for any more expenditures under the law. If we had any more expenditures, they would trigger a sequester. And, if I could take just one minute.

Senator MOYNIHAN. Sure. Please.

The CHAIRMAN. Yes, of course.

Mr. DARMAN. I did want to note that this is not a very effective chart. It is only one color. One color charts give me problems. [Laughter.]

But if I could just make one point, there is a version of this chart in the first part, in my introduction.

There is a category that we call "Investment in the Future," and within that category you will note that we point out that the level of investment in infrastructure that we propose is at a record level. Yes, you are right; it could have been even higher.

But we thought it important, within the cap, to also achieve a record level of investment in research and development, which we proposed within that same cap of $76.6 billion; the record level of investment in Head Start, $2.8 billion; investment in children's

programs overall—some discretionary, some not—of over $100 billion; and the math and science initiative of $2 billion.

These investments, many of which have the characteristic that they do not produce jobs immediately, would not be as attractive to Senator Riegle, I would presume, as the short-term objectives we identified.

But if we are going to address the long-term productivity problem that so many of us have referred to, we not only have to increase savings—as several have suggested—we also have to increase intellectual capital, R&D, the quality of human capital, Head Start.

Now, Head Start, which is for children 3 to 5 years old, is not going to produce an economic return that is favorable for the society as a whole until those children are working, and working more productively than they otherwise would have done. That is probably a decade-and-a-half to two decades away.

So, there is a balancing that has to be done, putting our interest in both short-term investment and long-term investment. We do not disagree with you about the positive value of infrastructure. We put it on our list.

But we also think that within the cap there ought to be other categories that have to be attended to as well. And our worry is that within the overall cap, instead of these record levels of investment in all these things that will increase jobs and productivity, there may, instead, be a tendency to move money towards short-term consumption, which we do not think is in the best long-term economic interest.

I trust you will note, with pleasure, that I have refrained from mentioning one other possible reason for the reduction.

Senator MOYNIHAN. I have noted, and I think you spared yourself a rather fierce response. [Laughter.]

Thank you very much. But, again, I think, sir, you just described your dilemma.

Mr. DARMAN. It is all of our dilemma.

Senator MOYNIHAN. That cap is the consequence of the deficit, and to use public resources to stimulate the economy is your dilemma.

Mr. BOSKIN. It is the Nation's dilemma.

Senator MOYNIHAN. It is the Nation's. Sure.

Mr. BOSKIN. It is Congress', the President's; it is everybody's dilemma.

The CHAIRMAN. Mr. Secretary, let me congratulate you on some of the short-term financing you have recently done. You and I discussed this months ago, having the government do more short-term financing while we have seen these rates of interest quite low on short-term. So, I am pleased to see that.

But let me pursue Senator Roth's comments a bit about the Bentsen-Roth IRA. What we are seeing from the administration is a so-called back-ended IRA. I think that you will see more of the shifting of savings there. And we recognize that. That has merit to it.

But having the front-end deduction, I think, is absolutely critical to bring back that feature of the original IRA. People understand it. They sit down there on April the 15th and decide whether they

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write a check to the IRS or they write it to their IRA. And I think with a $2,000 deduction that they will have an incredible incentive to write it to a savings account.

When you look at the Japanese with a $45,000 per capita savings, and us with a tenth of that; when you see them saving at a rate over three times as much as we do, and the West Germans over two times, you can understand how important it is to get our savings rate up, and capital so we can modernize and increase the productivity of our country.

But, first, I would hope that we in the Congress can pass it with the kind of bipartisan support we have seen. Then I hope the administration would accept it. Do you have any comment on that?

Secretary BRADY. Well, Senator Bentsen, I would offer only this. I feel strange arguing in any way against the initiative that you and Senator Roth have put forward, because I think the basic strategy and philosophy addresses problems which are enormously important to this country, and one that we should all support.

As you understand, we have a slightly different proposal in the President's budget which is less costly because of the pay-as-you-go restrictions. But I think I will let my comments stand there. I do not want to in any way seem critical of the thrust behind your and Senator Roth's philosophy.

The CHAIRMAN. Well, then let me ask you another one about a question of real estate. You have done a number of things on real estate here, but one of them I would like for you to explain to me. You have an over supply, particularly of commercial real estate for a number of reasons: over-building, credit crunch, recession. But, as I understand what you have done when we are talking about the incentive in this, what we would want to do, it seems to me, is to do things to increase the value of existing real estate, particularly to try to help the resolution trust disposal and the FDIC disposal.

But, as I understand what you have done, the incentive you have put in there is to increase the supply, in effect, for the incentive to construct new buildings rather than buy existing property. It seems to me that is counterproductive.

Secretary BRADY. Well, first of all, the capital gains proposal, Senator Bentsen, that is in the President's proposal does, we think, provide a substantial possibility for real estate values, particularly in the commercial sector to increase in value and to have consequent salutary effect on banks.

The passive loss proposal, which does aim at real estate generally and not completely towards new real estate, also benefits substantial construction improvements for old real estate would be included.

I think that before we complete the design of the exact provisions, it will have a significant effect on existing real estate.

The CHAIRMAN. Well, then let me deal with the capital gains question a bit when we are talking about depreciation.

As I understand your capital gains proposal, you would call for a recapture of the depreciation, and you would pay a tax on that at ordinary rates. That one would pick up some $5.4 billion tax increase on real estate owners. How do you explain that one when you are talking about a depression in real estate?

Secretary BRADY. Well, I am not sure I exactly have the point in mind that you are expressing. But if——

The CHAIRMAN. You changed the depreciation schedule, as I recall, where you have accelerated depreciation and that type of thing. I can understand that.

But when you are doing it to straight line depreciation and you recapture that paid at the ordinary income tax rate, my understanding, in looking at your charts, is that you pick up sp$5.4 billion in that process. In fact, that is an increase in the tax.

Secretary BRADY. Well, the real estate people have come forward with—and I think this may be at the bottom of your concern—a few cases where, because of the recapture provision, that they come out worse than under current law.

The reason we have a recapture provision in there is that, in its absence, the effective capital gains tax on real estate projects could be zero or negative. That is certainly not what we intended, and, I am sure, not what Congress intended.

The CHAIRMAN. Thank you. Senator Breaux. On the order of arrival, I see that you are first.

Senator BREAUX. Thank you, Mr. Chairman. I see in your budget proposal that you are calling for extension of the IDB program—Industrial Development Bonds—but for farm purchases only—first time farm purchases—but not for purchasing of small manufacturing operations.

And if the whole idea of your budget is to create jobs to get the economy moving, why did you drop IDB's being available for purchasing of small manufacturing and limit their use only to farms?

Mr. BRADY. Well, we thought that in trying to put together an across-the-board proposal in the whole of the President's plan, it was thought that there were other incentives for small manufacturing firms, such as capital gains tax decreases; the help on the investment tax allowance; and that they were taking care elsewhere and that the farmer of small farms was not. So, that was the reason for it.

Senator BREAUX. Well, I think if we are going to extend IDBs we ought to extend it for small manufacturing as well. But I am sure that is something we will debate.

Let me ask you about doing something for the training of workers in this country. Some of the estimates that I have seen from publications say that even by the most liberal calculations, the combined State, local, and Federal education funds that we are spending for non-college use is approximately one-seventh of society's combined investments for college-bound youths.

And I think that is a startling statistic. It is no wonder that we have a problem with competitiveness and productivity of our workers if we are only spending one-seventh of budgets on those kids who are not going to college.

Sixty percent of those kids going to high school do not go to college, and I think there is a terrible neglect out there in society for those who are not going to college; those who are going to be the electricians, and the carpenters, and the pipe-fitters, and the welders, that do not need to go to college. And we are not doing nearly enough.

I have introduced a bill that Congressman Rangel and Congressman Grandy have over on the house side basically setting up a youth apprenticeship program.

And the tax component of it is called the LEAP program, which stands for Leading Employers Into Apprenticeship Programs, which would allow the establishment of 501(c) tax exempt organizations to help participate with business and high schools in establishing youth apprenticeship programs. The idea is to give these kids who are not going to college some kind of hope that when they get out of high school they can have a high school diploma, and they also can have an apprenticeship certificate to let them be capable of getting a job and being more productive.

And my question is, what are the administration's thoughts on that concept?

Mr. BOSKIN. Well, Senator Breaux, let me just first applaud you for focusing on something that I think is quite an important problem.

We focused a lot of attention in this year's Economic Report to the President on the fact that the less-educated, and, to the extent that skills are correlated with education, less skilled part of the population is the part of the population that has had the most difficulty in the last couple of decades.

The part whose real wages have either not risen or risen the least, as opposed to the gains made by those who have gone on to college.

So, I do think that you are exactly right; that a serious part of our productivity problem involves that group in the population and future cohorts of people who do not go on to higher education.

Clearly, some of what is required is an improvement of the education system. We have about $18 billion going to the Job Training 2000 program which, we believe, will make many of the 60 different job training programs that exist throughout the government more efficient and more effective.

But I think you have some very interesting ideas. I will take a closer look at them, and I am sure my colleagues will. I do not know if they have looked at them in great detail yet, but I think they are certainly worth looking at. I think Mr. Darman would like to comment on them.

But, certainly you are right; if one looks at labor market dynamics over the long term, abstracting to the extent possible from current difficulties, over the last two decades there has been a shift in demand to higher skilled, more educated workers. This shift has even occurred in occupations and industries which traditionally have hired a much larger fraction of people without a college education. People on assembly lines for example, many need to learn to use computers.

I would also like to note that the deductibility of interest costs on education loans is for vocational as well as college education.

Senator BREAUX. I realize that. Mr. Darman.

Mr. DARMAN. Thank you, Senator Breaux. I would just add that if you have not already looked at the Job Training 2000 proposal we have, I think you would find it of interest.

It is intended to help the population that you are talking about get better training, not only when they are young, but also as they mature in a rapidly changing work environment.

With respect to the specific proposal, LEAP, I would just note that although we have not proposed it in our budget, we did support it on the House side when it came up for a vote, but it was not allowed in order by the House leadership.

Senator BREAUX. I would make a final comment on this real quick, Mr. Chairman, and beg the indulgence of my colleagues.

I think that the programs that take effect after someone is out of high school should not be our only focus, since we have lost them before then, in many cases. I mean, they have quit high school, they have become frustrated, they get thrown out of high school because they do not see any connection with what they are doing in high school and what they are going to be doing in the real world.

So, if we can bring programs directed towards the high school level and combine them it with businesses and high schools in a youth apprenticeship program, I think that is the time to catch them, as early as possible. And than you for your kindness.

The CHAIRMAN. Thank you. Senator Chafee.

Senator CHAFEE. Thank you very much, Mr. Chairman. Secretary Brady, I certainly agree with you that there is no silver bullet here. There is no instantaneous cure for the problems we face.

And so, I join with you in lamenting that this Congress did not do something about the banking situation, bringing our banks into the modern era and making them more competitive; something that you have worked so hard on.

I might say I believe in most of the proposals that you have outlined. I also believe in the two bill strategy.

I know the Chairman does not, but I think let us get going with these early solutions, stick to the March 20th deadline, which, in itself, is going to be hard to meet. And then when a big tax bill comes along, fine, but I think we all recognize that is going to take longer.

I would like to ask you and your colleagues about this ITA; the Investment Tax Allowance. I have talked with many, many people on what we should do to get jobs in our country.

I mean, that is what I am interested in, that is what you are interested in, and that is what the people I represent are interested in. As I mentioned before, we are undergoing in my State some extremely difficult problems.

We have the third-highest unemployment rate in the country, and it is going to be aggravated by the closing of defense industries, particularly the cut off of submarine construction.

So, therefore, I believe in the Investment Tax Credit as opposed to your allowance, which seems so minimal. And, indeed, if you look at the charts of the corporate income tax and realize that the rates obviously are low: it is 15 percent on the first $50,000, and so forth.

So, the tax on the first $100,000 of earnings is only 22.25 percent. So that a small business can get much more advantage from an income tax credit than it can from an income tax allowance.

And you, yourself, in your testimony—I believe it was you, Mr. Secretary—pointed out that the job creation area is with the small

businesses. Can you explain why you did not go for a credit as opposed to an allowance? I recognize it is more expensive.

Secretary BRADY. Well, it is per dollar of investment. If you want to meet the pay-as-you-go provisions which are so important to keeping interest rates down in this country of the budget agreement then per dollar of the tax credit or tax allowance, you get more bang for the buck the way we have proposed it.

In other words, if you assume that the dollars spent on investment incentives are going to be the same, then I think it is much more effective in the first year on a cash flow basis to get things going. And most of the people that we have talked to, Senator Chafee—the NAM and others—have come to recognize that this is accurate.

Senator CHAFEE. Well, we have been talking to different people. Do you have anything to say on that, Mr. Boskin? Now, take a small business. What you are suggesting is that you accelerate the depreciation at 15 percent. Well, if you are in the 22 percent tax bracket, a 15 percent accelerated depreciation is not going to do you much good.

Mr. BOSKIN. Well, you are quite correct that there is a graduated schedule for the first small amount of earnings for corporations. So, in that analysis you are quite correct.

And I think one of the aspects of the investment tax allowance approach that has not been appreciated is that by giving extra depreciation in the first year, it will particularly help those firms that are having difficulty obtaining credit.

It will give them some extra cash flow early on, even though later on there will be some make up of it.

Obviously investment tax credits have been used in the past, and my reading of the history is they have certainly been somewhat successful in stimulating the economy.

They have some other side consequences in reallocating investment that some people would be concerned about. And, as you, yourself indicate, they are costly. There is some re-flow of revenue, but they are quite costly and they would widen the budget deficit and would have to be financed.

Senator CHAFEE. Well, I would like to ask this of Mr. Darman. We talk costs here, yet you folks have come in with this personal exemption of $500 per child. If somebody is in the 15 percent or the 28 percent tax bracket, this is really peanuts.

I mean, I averaged it out between the 15 percent and the 28 percent and it comes to 29 cents a day per child. Now, is that going to stimulate the economy?

Mr. DARMAN. No, not in our view, although it is, in the view of some others, going to stimulate the economy. But we are not of that school.

We have included the increase in the personal exemption for different reasons: not for reasons related to an effort to stimulate growth in the short-term, but rather with a view toward trying to relieve some of the stress on families over time.

The personal exemption, as you know, was adjusted in the not-too-distant past upward, but it has not been adjusted nearly as much for inflation as it should have been relative to its origin. That would require thousands of dollars, not just $500.

And $500 is all we felt we could afford, looking at the need, as Secretary Brady and Chairman Boskin have said, to show some degree of fiscal discipline, and not scare long-term financial markets, and not be counterproductive by driving up interest rates, loan rates, and costing the very jobs we are trying to create.

So, there was a balance that was struck there, trying to adjust in a pro-family way and an orderly way. In fact, as you may know, the effective date for the personal exemption, as we propose it, is October 1, and it is not part of our short-term package.

Senator CHAFEE. Well, Mr. Chairman, my time is up, but let me just say, to the people I represent, this $5 billion a year is costly. They would rather have that money put into job-creating efforts rather than 29 cents a day per child.

Mr. DARMAN. I would just repeat, it is not in our short-term package, it is in our long-term restructuring proposal.

Senator CHAFEE. I appreciate that. Thank you, Mr. Chairman.

The CHAIRMAN. Surely. Senator Riegle.

Senator RIEGLE. Secretary Brady, is the President still proposing to tax the inside build up on insurance annuities?

Secretary BRADY. Well, not with respect to insurance annuities that have a life component. But if it does not have a life component, the answer is yes. And it is not in the short-term bill.

Senator RIEGLE. Well, it looks to me like the short-term/long-term—Chairman Bentsen got into this—if you have taken your package and you have cut it in half, and you want to do half of it now and half of it later.

And, you know, I think when the President, in all fairness, gave his State of the Union message, he put the whole thing out there. There was no differentiation between some now, some later. And, I must say, I think this is a highly questionable approach here.

But I want to move on to a couple of other things. I am with you on the Investment Tax Credit. I think that is an important part of your package, and I think there is broad agreement on that, and we need to drive investment forward at a faster rate.

Secretary BRADY. Tax allowance. Yes.

Senator RIEGLE. And the same thing with respect to the research and development area. I think this is another area where I think there is consensus, and we ought to move more strongly.

I would like to urge you also to take a look at the depreciation schedule on business vehicles. It is 5 years now. Your own studies show that something closer to 3 years is an accurate figure.

I think if we could accelerate sort of the capital recovery side of that area, I think we could help in that regard also, in terms of some parts of our economy.

Now, I want to just observe, we were talking earlier about the need for jobs, and Senator Chafee makes the point about how we really get some muscle out there in the way of jobs, and not just a few cents per day.

We have got a lot of highly-skilled people, and, relating to Senator Breaux's comment, a lot of highly-skilled people today unemployed who want to work. And I mean people who do not need job re-training, they just need a job.

I mean, they have got loads of jobs skills in computer areas, in teaching skills, engineering skills, financial analyst skills. High-level people all across the board cannot find work.

So, that is quite separate from the need to give job skills to somebody who is in an area where the country is not doing work in that area, but we have got a much deeper problem than that.

And I am wondering this. I know the President has announced his re-election campaign today, and one of the questions he is bound to be asked and should be asked is on this job goal that I referred to earlier; the one he set out there as a marker when he was first running.

And he is about 14 million jobs short of his own goal as we sit here today. And Chairman Boskin has said it looks pretty bleak the rest of the year because you are kind of hemmed in as to whether you can get major job growth toward that goal.

I would like to ask you to consider sitting down again with a group of people who would like to try to figure out a way in which, with the Congress and the administration, on a bi-partisan basis, we come up with a much larger and stronger economic strategy that gets more jobs on line faster for people who have job skills and who need work.

You know, it is one thing to talk about Head Start; I am all for Head Start. But if kids are going to get to Head Start, they have got to eat in the meantime; they have got to have a roof over their head; and they have got to have a family that is in a situation to have an income.

I have talked with countless people in Michigan today who are unemployed highly-skilled workers who are having trouble feeding their families. So, you know, this is a very urgent problem. And I think it is screaming at you in the data.

Today, in the Public Opinion Polls, 80 percent of the people are coming back and saying they think we are on the wrong economic track going into the future because of what they see happening.

I think we can put together a much stronger plan, but we are not going to do it if we do not decide that that is the need, if there is a detachment from that problem, if there is a feeling that somehow things will sort themselves out down where the citizens live and it will work out, and if there is hardship, you know, that is the best we can do.

The country is not going to accept that. And rather than put everybody through that kind of a continuing trauma, I think we need a bigger and stronger plan.

And I would like to urge you to call in some of the business leadership and some of the labor leadership and the key leaders in the Congress and sit down and figure out how we help the President keep his promise on job growth.

I do not think it is fair or proper to allow the level of difficulty to exist in our society and simply say, you know, that is the best we can do.

I mean, that is not what he said when he ran. When he ran he said we can do better than that, and we can do better than that. But not with an anemic plan. And even the plan you have got, you come in here now and you have cut it in half. You are saying, well, let us just do part of it; we will do the rest some other time.

Secretary BRADY. Senator, you have raised a number of items which I would care to comment on, if you would allow me.

Senator RIEGLE. Please.

Secretary BRADY. First of all, I hope you will agree that having a goal for increasing jobs, even if it is an expansive one, is a good thing. You would agree with that, would you not?

Senator RIEGLE. Absolutely essential.

Secretary BRADY. So, you are not criticizing the President for having the goal; not at all.

Senator RIEGLE. No. We need the strategy to implement the goal.

Secretary BRADY. Trying to do things and having a goal is a very good objective. And you would agree that a man that put out that as a goal is on the right track.

Senator RIEGLE. Well, no. I would say——

Secretary BRADY. He is not on the right track?

Senator RIEGLE. No, we are not. That is the problem. The goal was fine 3 years ago. We are off the track. We are 14 million jobs short of his goal.

Secretary BRADY. But having the goal is a good idea.

Senator RIEGLE. Yes. But falling short by 14 million jobs is a bad idea.

Secretary BRADY. All right. Well, of course. But still, that should not make somebody trying to have a goal or objective be criticized for that goal. It is obviously a good thing; you have just said that.

But secondly, I would point out during the last 4 years since he put that goal forward, none of his economic programs have been enacted. They cannot get through Congress. So, I share your entreaty completely; we should sit down and do something about that. And the President has been trying to do that. So, it is not a complicated process.

If the program that he puts forward created 50 jobs in a thousand cities, that would be 50,000 jobs a year. If those people each earned $20,000 a year, that would be $1 billion a year, so that at the end of 5 years, you would have $5 billion more in the economy and 250,000 more jobs. I think that is the way you have got to get at it.

Senator RIEGLE. Well, with all due respect, Mr. Secretary, what the President promised by this point in time from the beginning of his Presidency was 14 million additional jobs. We do not have them.

I mean, there is a gap in that area. And the problem is, you have come in with a plan today that creates very few jobs through the rest of the year, according to your own testimony today. So, you are not coming in with a plan to meet the goal.

Secretary BRADY. But you are certainly not criticizing the President, I hope, for putting out an ambitious goal for job creation. I cannot understand it. I mean, that would be counterproductive.

Senator RIEGLE. Again, you are sawing it in half. It means nothing to have the goal if you do not have a plan to accomplish the goal.

Secretary BRADY. Well, Senator, we just disagree. I think the sawing in half is the half that Congress has not delivered in getting his programs through.

The CHAIRMAN. Gentlemen——

Senator RIEGLE. Well, if you sent a program up here to create 14 million jobs——

Secretary BRADY. I think he has done that.

Senator RIEGLE. No, he has not done it. That is the problem.

The CHAIRMAN. Gentlemen, the time has expired again. Senator Roth, if you would proceed, please.

Senator ROTH. Thank you, Mr. Chairman. As I said in my opening remarks, I think the President had propounded a program that gives us a good base from which to work and I think it is important as we proceed that we proceed in a bipartisan way in an effort to do what is important to create growth and jobs.

I, as you know, am in favor of cutting taxes. There is not much question about that. And I am in favor of making it broad-based so that everyone benefits, but the middle class more than the rest. And it seems to me that we can do both.

Now, I proposed in my package that we cut income tax rates in order to give the economy a boost, improve incentives to work, save, and invest, and give a break to the middle class.

Some think this proposal is too expensive, but I do think it can be made to fit the amount of money that we can afford.

For example, we could lower the bottom rate of 15 percent to 12 percent, and everybody would get a tax cut, but especially the lower- and middle-income groups.

With the earned income tax credit, CBO estimates that this would be a dramatic cut for the lowest income earners. Would this not do more to improve the economy and provide incentives, as well as get the money to the right people?

Mr. BOSKIN. It depends on what you are comparing it to, Senator Roth. I believe that some of the targeted investment incentives and things that would help raise asset values, prevent asset values from falling, and help increase consumer confidence, would help increase investment, as Senator Chafee was talking about.

If you are comparing this to things that are in the exemption as opposed to the rate, then certainly it is correct that there is an incentive effect from lower rates, that, other things being equal, would be desirable.

But obviously there is an issue of how it would be financed, or whether it would be wise to raise the budget deficit, given what is inherited and what is prospective.

Senator ROTH. But that proposal, if we can work out how we pay for it, would provide incentives to invest and to save and would go primarily to the lower and middle income, is that correct?

Mr. BOSKIN. That is right. The incentives are defined at the margin. I would not make a big deal out of it because the rate of 15 percent is already quite modest. But certainly reducing the rate would have an incentive at the margin that a change in the exemption would not.

Senator ROTH. Well, as I said, the CBO estimates that it would be a dramatic cut for the lowest income earners. But going back to the investment tax credit, as you know, the criticism is, again, that it is too expensive. And that is the reason I have proposed an incremental investment tax credit.

In other words, a tax credit would only apply where the company increased its investment over its average for the past 4 years.

Would that be a factor in helping promote, not only this year, but long-term, greater investment in new equipment, much like we have done in the case of research and development?

Mr. BOSKIN. I believe it might, if properly designed. I believe that when people have looked at it in the administration, they found that there were certain administrative difficulties in moving to something on an incremental basis when firms merge or split apart, for example.

It certainly begins to deal with the problem of giving away the base and the cost, and I applaud that move. I believe, however, that almost every economist would tell you that the temporary nature of the proposed investment tax allowance will move some investment into 1992; more than would be the case were that made permanent.

There may be other reasons to consider making something permanent, but more than would be the case were this proposal or an analogous one made permanent. And, as Chairman Bentsen indicated at the start, the economy needs some "oomph" right now.

Senator ROTH. Well, I agree that it needs some "oomph" right now, but equally, if not more important, is the need to become competitive long-term. And that is my concern with the administration's approach.

Mr. BOSKIN. I think the incremental approach clearly addresses one of the problems, which is the large revenue cost of the full ITC.

The CHAIRMAN. Thank you. I would like to call on Senator Moynihan.

Senator MOYNIHAN. Briefly, Mr. Chairman, let me, if I can, just speak as the Chairman of the Subcommittee on Social Security, to the matter in which we try to keep it bipartisan and we do think in terms of the Social Security trust funds. And the National Economic Commission, which was created by President Reagan, studied our Nation's fiscal policies and came forward with the issue of the extraordinary surplus in Social Security trust funds and the ethical question, it seemed to us, which our government had to face—Congress and the administration—namely, what would that surplus be used for.

Surely it should not be used as general revenue. And yet, in the next 5 years which we now budget, there is a surplus of $435 billion in the Social Security Trust Fund, and it is all destined to be used as general revenue.

May I just ask you, Mr. Secretary, a former colleague, and you know what regard we hold you here, if we go 5 more years using this surplus, it will have been built into our budget structure in a way it will never get out.

Have you given any thought to how we can break out of this pattern? Because it clearly is a breach of trust.

Secretary BRADY. Well—excuse me. Are you finished?

Senator MOYNIHAN. Yes.

Secretary BRADY. Well, as you know, the President's budget shows the deficit both before and after the trust fund.

Senator MOYNIHAN. It does. It does.

Secretary BRADY. And I will ask Dick Darman to comment on that. But this argument is such a difficult argument, because, after all, the Social Security trust fund surplus is invested in the most

safe, secure securities in the world, which are U.S. Government bonds. So, that is where I think it ought to be invested.

Senator MOYNIHAN. I know that and you know that. We also know—and you, as the principal trustee of that fund, sir—that, in effect, the money is being used as general revenue.

Mr. DARMAN. Senator Moynihan, if I could, let me take a couple of minutes on this. I know you recognize that the problem you are talking about will not be addressed until the non-Social Security budget is in balance.

Senator MOYNIHAN. I think that is right.

Mr. DARMAN. Your own commission report said that, and it is analytically, I think, inescapably correct.

So, a question is, what does it take to get the budget in balance—non-Social Security budget in balance? Only after you have done that is the Social Security surplus that you are talking about actually going to reduce debt, at which point it is increasing savings and increasing the ability to service the future baby boom obligations.

Senator MOYNIHAN. Right. But I would just make the point, and I think Dr. Boskin would agree, if we had a balanced budget in the general account, the Social Security surplus, by buying down the privately held public debt, would double the savings rate.

Mr. DARMAN. Right.

Senator MOYNIHAN. Right. Yes.

Mr. DARMAN. So, for this and other reasons, we should be talking about first, following your question, how do we get the non-Social Security budget back toward balance and then actually better than that?

Here is the problem. When we talked about this exact issue—as we did many times over the years past—the Gramm-Rudman system was in effect, and moving Social Security "off-budget" actually meant something when the Gramm-Rudman system applied to the rest of the budget.

Senator MOYNIHAN. Yes.

Mr. DARMAN. But, at the same time as we collectively moved Social Security off-budget, we temporarily suspended the old Gramm-Rudman discipline. So, there was a disconnect there. We half solved the problem, but, in only half solving it, we did not solve it at all.

Now, what we did is, we added on an interim basis a new discipline system with caps and with pay-as-you-go requirements for any new entitlements.

What we collectively missed was the built-in structure of all the old non-Social Security entitlements. They are not subject to any discipline; they are two-thirds of the budget, roughly, or moving toward that. And they are the most rapidly growing portion, interest put aside.

Until we get those under control, in my opinion, we will not be able to solve the basic deficit problem.

If I could, Mr. Chairman, if I could take one minute on one chart.

[Chart 2–6 appears in the appendix with Mr. Darman's prepared statement.]

The CHAIRMAN. Yes, of course. Sure.

Mr. DARMAN. This chart is actually somewhat readable.

Senator MOYNIHAN. Color.

Mr. DARMAN. Well, actually, now that I look at it, it is not very readable. But it is in the introduction, and the only point I want to make—I will show it if I can here—is that if you said what is the long-term deficit outlook in more or less a current services frame of reference, as estimated by the CBO, this goes to the year 2001, you see it comes from eye level where it is now, down, and then it turns moderately back up.

What you might think of as the baseline deficit is stabilizing as a percent of GDP, but in absolute dollars it is increasing slightly. If we have smaller growth, as everybody has suggested, the pattern is it still decreases a little bit in the short-term, but then it turns up more sharply. At this point we have serious problems because our debt, as a percent of GDP, does not stabilize; it starts to turn up, which is very unhealthy, in my opinion.

Now, what does it take to make these lines not do this? If you assume the enactment of the broad measures in our budget, and roughly 3-percent pure growth thereafter, and not doing anything more, the pattern is somewhat better.

By the way, we are not proposing to do anything more; but if we were not to do anything more, then the deficit would stabilize. That is not good enough. Reducing the deficit requires enactment of growth-oriented measures that will get our long-term growth at 3 percent or better, which requires investments in things that will improve productivity. It cannot happen otherwise.

Now, if you want to get the deficit actually across this black line and move into surplus, which you have to do, I believe, unless you are going to completely reduce to zero those infrastructure and other investment categories—and that is at your discretion—what you have to do is restrain the growth of non-Social Security entitlements.

When you restrain their growth rate to population growth—that is eligible population growth—plus the presumed price increase. Take eligible population, program-by-program, and add CPI—you would, in 5 years, save almost $400 billion, which is enormous, and you would make this line go right straight to zero.

Now, I do not believe that that is politically feasible, because a very large portion of this growth is in the health area. And though I wish we could have all come up with a program that would get the rate of growth of health down to eligible population plus CPI immediately, I think it is going to take many years to get to that point.

So, a more realistic expectation is—I think we did the right thing—to take both measures: growth and the entitlement cap and the line would go like this.

Senator MOYNIHAN. May I just ask you, because you said something with a touch of real reality that we all need, your topmost curve, the dotted red line, that is at a lower growth, which would be, what, about 2 percent? Is that what you would put that range in?

Mr. DARMAN. That is right. That is consistently 1 percent lower.

Senator MOYNIHAN. Yes. Which is in the range of possibility. At that point, we would find the debt as a proportion if GNP compounding—growing.

Mr. DARMAN. Growing, not compounding.

Senator MOYNIHAN. Growing.

Mr. DARMAN. Turning up. Yes.

Senator MOYNIHAN. And, in that sense, out of control.

Mr. DARMAN. Yes. Yes.

Senator MOYNIHAN. All right. Thank you very much.

The CHAIRMAN. I think everyone has had a second round except Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I would like to point out that we constantly deplore the growth of entitlements. I do not know whether the Director of OMB will be cheered by the fact that the committee dealing with it has reported out the Pell grants as an entitlement.

Also, there is legislation to make Head Start an entitlement, and the WIC program an entitlement. So, the lust for entitlements has not increased in this Congress; in this Senate, anyway.

Mr. DARMAN. Could I comment on that, Senator Chafee, briefly?

Senator CHAFEE. Briefly.

Mr. DARMAN. Not having it charged against your time. I just would like to say from a parochial OMB perspective, that I understand, and it is right that we are concentrated on the short-term measures to be enacted by March 20th, and that will not include entitlement reform, as far as I am able to judge.

But, if we are really serious about the long-term deficit problem, we cannot be increasing the portion of the budget that is in the totally uncontrolled area.

Indeed, we have to find ways to force annual review and some degree of control in that, or you cannot solve the basic savings problem that Senator Moynihan, Senator Roth, and others are rightly concerned about.

Senator CHAFEE. I agree with you. And pretty soon, if this keeps up, we can just put the Congress on automatic pilot and everybody go home, since everything is an entitlement.

Mr. DARMAN. Right.

Senator CHAFEE. Now, Secretary Brady, in discussing the capital gains, it seems to me—and I think you agree with this—that the argument should be, does it create jobs, or is it going to make somebody rich?

And, unfortunately, the argument around here in the Senate seems to be that if it makes somebody rich, it is all wrong. I am interested in whether it creates jobs. If it creates jobs and also makes somebody rich, that is incidental. I really want jobs out of it. That is what my people want in the State that I represent.

And, unfortunately, I do not think that your arguments have gotten through. And when you use language such as "unlocking job-creating investments," somehow it is not enough to sell the program.

Now, I have got a couple of minutes here, and I am lobbing you a soft one. Would you please tell us how cutting the capital gains rate is going to create more jobs in the country.

Secretary BRADY. Well, let us cut the capital gains tax into two parts. First of all, as Senator Breaux said earlier, 60 percent of people who take advantage of capital gains are people with incomes under $50,000.

Senator CHAFEE. I am not interested in the poor or the rich making money. I want to know whether there are jobs in it.

Secretary BRADY. Well, wait a minute now. That group is in the categories of small businessmen and small entrepreneurs where by far the largest part of job creation takes place. So, those are the people that actually put jobs on the line. Small businesses create most of the jobs. So, that is one part of it.

The other part is the wealthier part of the spectrum, and they have capital that is locked up. And the capital gains tax would unlock that capital to allow it to go to more productive investments. If a guy pays less tax, he is——

Senator CHAFEE. Well, could you describe what unlocking capital means? Suppose somebody has an investment in a stock that has gone up and it is up at 200 and it seems to be holding there. Now, tell me how he would unlock his capital. He would sell it, presumably.

Now, he does not want to sell it, because he is taxed at ordinary rates. But he thinks he sees something coming along in biotechnology. He would like to get out of what he is in, sell it, and invest in the biotech stock, for example. Is that what you are talking about?

Secretary BRADY. That is right. If he is taxed at 28 percent he is not going to sell it, and if he was taxed at 15, the chances are that he would because he would be able to get into this new job-creating investment and hopefully he would look forward to a profit on his investment. In the meantime, that company—the small, growing company that is putting jobs on the line—would be creating the jobs that we need. You put your finger exactly on the point.

Senator CHAFEE. But I think we have got too keep thumping away on this. And when you were up here last time we discussed this.

Is there statistical evidence—and I am on your side—that would bear out the fact that since capital gains were taxed at ordinary rates, that investment capital in this Nation is dramatically decreased.

Secretary BRADY. Well, what I can tell you is that the revenues that the government has received from capital gains taxes has declined significantly the period of time since the rate was increased again.

So, I think what you can prove is that the removal of the capital gains differential has decreased the amount of capital gains people are willing to take. And, therefore, the investments are locked up, as you have suggested.

Mr. BOSKIN. May I just add one thing to Secretary Brady's excellent description of unlocking effect?

Senator CHAFEE. Yes.

Mr. BOSKIN. A very large fraction of job growth comes from totally new businesses. The American economy's driving force is ideas, new businesses, new jobs, new products, innovation; whole new industries that did not exist even a decade ago, let alone 50 years ago.

And there is a substantial amount of evidence that a large part of the start-up funds, at the very earliest stages, come from people

who are taxable under the income tax. That is where a large part of the initial funding comes for these sorts of things.

And we also believe it would increase the supply of entrepreneurs willing to leave a stodgy job that is paying all right and go out and try to start something new.

But the idea of getting that creativity, getting the entrepreneurial spirit and innovation going—creating whole new products, processes, new jobs in industries that did not exist before—are enormously important, not only because of the net job creation, but because of the flexibility it will prove the economy when some existing industry restructures. It is going to be 90 percent as large as it is now prospectively over a decade or two. So, that is enormously important as well.

Mr. DARMAN. Could I add one other word, just briefly?

The CHAIRMAN. Yes, of course.

Mr. DARMAN. I, of course, agree with everything that has been said. And the most exciting and important reason, in my opinion, to adopt capital gains is the set of reasons that are talked about, and they involve the long-term. Productivity growth, biotechnology, all kinds of attractive, as yet unknown industries.

Let me just mention one thing much more pedestrian that applies in the current situation, in my opinion.

There are a lot of very small-to-middle sized business men and women who, today, are experiencing the so-called "credit crunch," and they maybe employ three people, 10 people, and they want to take that next step.

It is not particularly exciting. It is going to add three jobs here, seven jobs there, four jobs there; firm by firm. But they cannot get the credit for the next step. Just changing the capital gains rate—lowering it—improves their balance sheet immediately, even if they do not sell.

When they go to the bank, or whomever is lending them money, the balance sheet values their assets, and the after-tax value of their assets, improve, just by virtue of changing the capital gains rate.

And so, they can borrow more, they are a better credit risk, and they can go out, and, even if it is something that is low, low, low-tech—a pizza parlor that just wants to add a couple of more tables and one more oven—whatever it is, they are better able to get the credit for that next step forward that creates two jobs here, seven jobs there, four jobs there. And that, in aggregate, makes lots of jobs.

The CHAIRMAN. I think a lot of us feel that capital gains can be of help if it is properly structured. I have been one who supported that cut over the years, particularly when you had the high-income tax rate of 70 and 50 percent. Then the disparity, and the locked-in feature was really quite apparent.

But I have also seen middle-income folks take a real hit over the last decade. I have seen their taxes go up while their incomes went down. So, it is terribly important that we keep fairness in the tax system.

Now, when my friends talk about more people under $50,000 getting some income off of a capital gains tax cut, that also is a small amount as relative to those who are wealthier. So, I tried to do this

last time. I went to the President in 1990 and suggested that as we tried to get the budget agreement, that I would support a capital gains cut.

I suggested that those of higher income pay a little more to try to balance that out and keep fairness in the system, that we go to a 33 percent rate. But the President chose not to support that. I think we would have had this behind us, had they done that. Let me further comment when my friend, the Secretary of Treasury, talks about Congress not passing some of these things the President has proposed, I can recall back in 1990 in the budget agreement it sure took a bunch of Democrats to get that thing passed for the President.

And I have also seen the President's proposal in the State of the Union address already restructured by the Republicans in the House. They were not ready to take it. Sure. Let us try to work together in a bipartisan way to resolve it.

Gentlemen, I think this has been productive. We are appreciative of your attendance.

Senator CHAFEE. Does that mean we are finished?

The CHAIRMAN. Well, I just thought the Chairman had the right to finish it.

Senator CHAFEE. Well, there is no question about that. [Laughter.]

The CHAIRMAN. Thank you very much.

Mr. BOSKIN. Thank you very much, Mr. Chairman.

[Whereupon, the hearing was concluded at 10:23 a.m.]

ECONOMIC GROWTH AND THE PRESIDENT'S BUDGET PROPOSALS

THURSDAY, FEBRUARY 13, 1992

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

The hearing was convened, pursuant to recess, at 10:04 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Bradley, Mitchell, Riegle, Rockefeller, Breaux, and Chafee.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. If you would please be seated we will get underway. It is obvious that the weather and the bad roads have limited our participation. I regret that, but it is very important that we make the record and get these views known of the witnesses. It will be quite helpful to us.

I am also optimistic that some of these witnesses will overcome the road problems and we will see a respectable number of members of the committee here.

I am pleased to welcome the witnesses to the second day of the Finance Committee hearings on the President's Budget and on the Economic Recovery Proposals.

Yesterday the principal economic advisors to the President testified on the administration's plans for jump-starting this economy to try to establish a basis of prosperity for the long term. Today we are seeking reactions to the administration's program—especially the tax changes. We are seeking comments from economists and a cross section of American industries most directly affected by these proposals.

I think these assessments are pivotal to congressional investigation and action because many of today's witnesses are men and women representing the businesses whose hiring and investment decisions in the months ahead will determine the success of any recovery plan.

In his State-of-the-Union Address on January 28th, the President challenged the Congress to enact within 50 days an economic program that had taken him 90 days to develop. This week, some 15 days later, he is changing his plan and for all we know, there are going to be more changes to come in the days ahead. In that kind of resulting confusion it looks like the Ways and Means Committee

members will have to offer a smorgasbord of some three tax plans for House Members to chose from.

Now given the kind of vacillation that we have seen from the President, it is going to be very difficult for Congress to meet the March 20th deadline that he proposed. If he makes many more changes he may not meet it himself.

Nonetheless, the Committee intends to move as quickly as possible in the weeks ahead to enact an economic recovery package and, as we do, we will be making a lot of use of the observations and recommendations by today's witnesses.

Certainly there is disagreement on what form of an economic plan should be put into effect. Economists are forecasting a recovery for later this year. Of course, they have been telling us that for the last 18 months and that a recovery is only 6 months away.

The most optimistic are talking about "slow growth" at best: A very muddled recovery. Failure to match the average post-war recovery will cost the typical American family over $1,600 this year. Over the last decade you have seen taxes go up and incomes go down for middle income. And with 3,000 jobs being lost every day, our Nation faces the real specter of a double-dip recession, throwing additional thousands out of work and adding tens of billions of dollars to the deficit. I think we are skating on really thin ice concerning that.

We have to do everything possible to insure that that does not happen. And we must do what we can to insure that once a rebound gets underway, it is not the weakest since World War II as some have predicted.

So the Finance Committee is looking for ways to improve on the weak economic prospects and we will listen with a great deal of interest to the suggestions of the witnesses we have this morning.

But before we proceed let me stress that it is critical that we hear all viewpoints as we begin to address the Nation's economic problems: Both those of short term and those that relate to a long term economic help.

We need to know how the President's budget proposals would be expected to impact on individuals and businesses located across the country.

Unfortunately this very short time frame that we are faced with, and it has forced us to limit the number of witnesses that we can hear from today and the days of hearings that we would otherwise have at our disposal. However, we are going to give very careful consideration to all written submissions, including comments about the revenue raising proposals in the President's budget.

And therefore I encourage all who hear this statement—or read it—to submit your views in writing and to do so as soon as possible.

On the first panel—if you will come forward—Mr. Robert Gilbertson who is the Chairman of American Electronics Association, Shelton, Connecticut.

Mr. Robert Cizik who is the vice chairman, board of directors, National Association of Manufacturers and chairman, president and chief executive officer of the Cooper Industries in Houston, TX.

And I understand our other witness this morning on this panel has not yet arrived.

Senator BREAUX. Mr. Chairman?

The CHAIRMAN. Yes.

Senator BREAUX. Mr. Chairman? Over here.

The CHAIRMAN. Oh, Senator Breaux. Well, I am delighted to have to here. Would you like to make a statement?

Senator BREAUX. I just wanted to observe that the only two members that were able to brave the snow is the gentleman from Texas and the gentleman from Louisiana who has had great experience handling these snows back home.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. I am going to just make a comment, Mr. Chairman, if I might. I think you are right on track and right on target with the approach that you are suggesting this Committee take in a sense of doing a single package tax bill.

We are going to be fortunate to get one bill passed rather than trying to play with two tax bills, which I think would be very very difficult as we get into the political season. So I think the real challenge is just to get one good package passed in a proper fashion. So, I look forward to the hearing today.

We heard from the Administration yesterday and I was somewhat encouraged about their comments on the capital gains tax bill that I have introduced which has a safety net to pay for it if, in fact, it does not generate new revenues.

It seemed to me that their main concern was one of technical drafting: What a proper baseline would be to figure whether we really generated gains or found losses occurring; that can be taken care of, and our bill should be ready for introduction at the beginning of next week.

I thank the Chairman for having the hearing today.

The CHAIRMAN. Mr. Gilbertson, if you would proceed, please.

STATEMENT OF ROBERT G. GILBERTSON, CHAIRMAN, AMERICAN ELECTRONICS ASSOCIATION, SHELTON, CT

Mr. GILBERTSON. Thank you, Senator. Mr. Breaux, I was privileged to see your talk to the Adventure Capitalists last Thursday and was very impressed with your ideas.

The American Electronics Association, which I represent, represents 3,500 American companies located through the United States.

The American Electronics Association member companies span the breadth of the electronics industry, from silicon to software to all levels of computers and systems integration. The giants of the industry—for example, IBM, Hewlett-Packard, Motorola, and AT&T—are AEA members. At the same time, almost 65 percent of the AEA members are small companies with less than 125 employees and revenues of less than $10 billion.

My company, Data Switch, designs, manufacturers, sells and services high-speed connectivity devices that allow users of mainframe computers to assure continuous availability of their computing networks. And Data Switch currently employs 650 people, most of whom work in Connecticut.

Mr. Chairman, I want to focus my talk today on the tax policy, capital formation, and the high-technology industry.

No single tax proposal, capital gains or any other will solve our competitiveness problems by itself. The AEA recognizes that any plan to encourage growth must be a comprehensive one that includes changes in trade, government procurement, and science and technology policies.

We also realize that the industry must do its share. We must provide the best in work force. We must insist on the quality of all of our products and services. And in this regard, I am delighted to tell you that all three winners of the 1991 Malcolm Baldrige Quality Award were AEA members.

I should note, Mr. Chairman, that much of what we propose, the AEA, in the tax area already has the strong support of Congress. On many of our issues, we simply want to encourage your continued support.

If there is a common theme to the AEA's legislative tax agenda is that we must begin to encourage long-term investment in R&D and new technologies in this country. The need for such investment cannot be overstated.

The U.S. production share of electronics has declined by one-third since 1985. Well market share has fallen by one-third in production—from 52 percent to 35 percent. This translates into a loss of 250,000 manufacturing jobs. Moreover, U.S. leadership in electronics is under serious challenge and may soon be eclipsed by Japan.

Like most of Congress, we agree that the Research and Development Tax Credit represents good public policy. A recent study by two respected economists said that the Credit—and this is a conservative estimate—adds $2–$3 billion to average annual R&D spending—encourages spending, in other words. We need, of course, to make the Credit a permanent part of the Tax Code since only then will its incentive value be fully felt.

On the research and development allocation rules, we want to encourage the support you have demonstrated but also we urge that you make a moratorium on the 861 rules a permanent part of the Tax Code. The electronics industry believes that we should not encourage American companies to move their research and development overseas, which is exactly what the 861 rules do.

Another area of significant concern to the AEA is legislation recently introduced in the House. The House Bill 3035 requires companies to amortize intangible assets over 14 years. Most high-technology intangible assets have economic life closer to 3 years.

While the AEA supports the concept of tax simplification, House Bill 3035, as currently drafted, would significantly raise our industry's after tax cost of capital and would hurt, in no uncertain terms, our ability to compete with foreign nations.

Finally, on capital gains, close to 50 senators—including many on this Committee—have cosponsored the Enterprise Capital Formation Act. The AEA believes this legislation will encourage long-term investment in smaller companies, and we are gratified by the strong support it has received.

One of the most telling benchmarks of American competitiveness pertains to the ability of emerging companies to raise capital. The

bottom line is that American entrepreneurs in today's financial environment are unable to do so.

The lack of capital availability, of course, can be seen in the decline of institutional venture capital financing. The peak year for ventured capital financing was 1987 when we reached $4.2 billion. In 1991, only $1.34 billion was raised—less than one-third.

This funding shortfall has created a dramatic decline in the number of new companies which has dropped from 1737, which attracted investment in 1987, to just over 1,000 in 1990.

More importantly, however, has been the withdrawal of the individual of the "informal" investor from the long-term, high risk marketplace. These investors, I should note, are very sensitive to the tax rates on their investments.

Mr. Chairman, when equity financing disappears so do emerging companies, taking their jobs and cutting edge technology with them. Entrepreneurs have nowhere else to turn. Generally speaking, the conservative nature of the banking industry, which includes banks and other "debt" institutions, as a source of investment capital, are drying up.

This situation has not always existed. The early and mid-1980's were the Age of the Start-Up, a period when investment in high technology flourished and a period which produced such giants as Sun Microsystems, Microsoft, Compaq Computer, and Conner Peripherals among others.

America has benefitted from these companies. We have benefitted by their exports, the thousands of jobs they have created, the cutting edge technologies they have produced. But because of today's scarcity in seed and venture funding, we are failing to create a new generation of such companies.

The reason for the decline in U.S. capital availability are many: For one thing, the cost of creating new companies has risen beyond comprehension.

Clearly entrepreneurs are also being hindered by a short-term mentality in the financial world. And finally, we are hurt by the elimination of the differential on capital gains.

It is no coincidence that equity financing for emerging companies began its precipitous decline after the Tax Reform Act of 1986. While not the only factor, the elimination of the differential has discouraged long-term investment in smaller companies—companies which are the leading source of job creation in this country.

Indeed the relation between the capital gains rate and the equity financing is dramatically shown in an Appendix A of my testimony or on this Chart on my left.

The CHAIRMAN. Mr. Gilbertson, I will have to ask you to summarize so we can have time for the questions.

Mr. GILBERTSON. Okay. All right.

It is for these three reasons, Mr. Chairman, the AEA supports a restoration of the capital gains differential and has so enthusiastically endorsed the Enterprise Capital Formation Act.

Mr. Chairman, helping entrepreneurs find equity financing is, of course, only have the battle, and we need the R&D tax credit, and we need 861 relief and we need to have the long-term amortization rules kept reasonable within the life of the equipment. That is why we support those issues.

So encouraging long-term investment in the U.S. R&D, new technologies, and the ideas of our entrepreneurs is ultimately what we are seeking to achieve. And we believe no goal can do as much to create jobs and to stimulate new growth.

Thank you, Mr. Chairman.

The CHAIRMAN. That is an interesting testimony. I note we have the arrival of the majority leader and realizing the limitations on his time, I would like to call on him now for any comment.

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

OPENING STATEMENT OF HON. GEORGE J. MITCHELL, A U.S. SENATOR FROM MAINE

Senator MITCHELL. Mr. Chairman, thank you very much for your courtesy, and thank you for holding these hearings, which I believe are proving to be extremely informative and helpful to members of the Committee, the Full Senate and the public in understanding the issues that are before us in this discussion on Tax Policy.

I want to first thank Mr. Gilbertson for his testimony and apologize, Mr. Chairman, that I will not be able to stay for the full hearing because of other commitments. But I also wanted to comment, if I might just briefly, on a couple of aspects of the Tax Package that has been submitted in behalf of the President, and which I gather will be before this Committee in the near future.

I was deeply disappointed to learn that the President did not include in his priority tax package either a middle income tax cut or the provision to repeal the luxury tax on boats.

We had been heartened by the President's statement in his State of the Union address and his budget that he supported both of those measures. But now we are told at the very last minute that those are, under the President's plan, to be consigned to some later time. I believe the words used in a quote I saw in the paper yesterday were by the President "to the political dance later in the year."

I think, Mr. Chairman, you have correctly stated and the Chairman of the House Ways and Means Committee have correctly stated that doing it "later in the year" or "in a second Bill" usually means not doing it at all.

I fear that the decision by the President represents, in effect, an abandonment of support for cutting taxes for middle income Americans while intensifying support for reducing taxes on those at the very top of the income scale. And also represents, in effect, an abandonment of the effort to repeal the luxury tax on boats.

I think it is significant that the two leaders in the effort to gain that repeal are present today; Senator Chafee and Senator Breaux. And I hope that they are as concerned as I am about this decision by the President and will join—Mr. Chairman, I know you had indicated previously you will include that in the legislation that you offer in the Chairman's mark—to see that that is included in the first train that leaves the station and very likely the only train that leaves the station and is not consigned to some indefinite later date or second bill or political dance later in the year.

I believe both those measures are important and ought to be included, and I hope they will be included, Mr. Chairman. I look forward to working with you and I know Senator Chafee and Senator

Breaux, at least with respect to the boat tax, share the views which I have expressed.

The CHAIRMAN. Well, thank you, Mr. Leader. I must say that I have had the experiencing of the offering of two tax bills before, and my experience is that the second bill just never shows up. We ought to put the entire package together and try to get it passed.

I would like to now recognize——

Senator MITCHELL. Mr. Chairman, if I might add, that is especially the case since, as we all well know, under the Constitution, we cannot originate a tax bill in the Senate; it has to come from the House. And the Chairman of the House Ways and Means Committee has already said there is only going to be one tax bill.

With that being the case, it seems to me that suggesting that we wait for some indefinite second or future tax bill effectively means what you have just said—that there is not going to be anything more than that first bill.

The CHAIRMAN. Senator Chafee, with any comments.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you very much, Mr. Chairman. As the Majority Leader so well pointed out, Mr. Chairman, we are relying upon the strong support that you have given to the repeal of the Boat Tax and I believe you have extended that support to the repeal of the Airplane Tax as well.

You had previously indicated that any bill that came out of this committee—that left this station—would contain the boat tax repeal. So I find that very heartening and, indeed, you had also indicated that you would have it retroactive to January 1st, which makes me a very enthusiastic supporter of any measure you are for.

The CHAIRMAN. That is at some comfort nonetheless.

Senator CHAFEE. Now as for whether it will be two bills or one bill, we can debate that back and forth. All I hope is that we get something done quickly.

As you know, the President has set March 20th as a deadline, and I would certainly hope that we could meet that. If we are going to get laden up with a whole series of other things, I just think the more you put on this particular train, the later the train is going to be from leaving the station.

I feel that there is a time urgency here and the limited number of items the President suggested, as I count them, are some seven plus the luxury tax would make it eight. That is a package that we could handle, and handle probably pretty quickly here.

So I would hope, most of all, that we would get on with meeting that March 20th date.

The CHAIRMAN. Well, my problem, Senator, is the President keeps changing the package and has changed it as late as this last week, and I don't know what further changes will be forthcoming and that is my concern.

I just hope that the President can meet the March 20th deadline with whatever he proposes.

Mr. Cizik, if you would proceed, please.

STATEMENT OF ROBERT CIZIK, VICE CHAIRMAN, BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF MANUFACTURERS AND CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COOPER INDUSTRIES, INC., HOUSTON, TX

Mr. CIZIK. Thank you, Mr. Chairman. When I left Houston two nights ago, I thought the weather there was bad.

In summarizing my prepared statement, I want to focus primarily on incentives for business investment. The President has made two proposals in this area:

The first is to reform the Alternative Minimum Tax (AMT) to reduce the negative impact of that tax on current business investment. We think this is a major step forward conceptually that deserves our strong support.

The corporate AMT is based on the flawed idea that corporations should, for the sake of appearances, send some tax payments to the Treasury every year; regardless of surrounding realities such as recessions and lack of profits or cash flow.

It is especially harsh in its effect on corporations having made heavy capital investments in prior years when profits were good and who are now experiencing low or no profits.

The AMT is withdrawing cash from these firms which could more advantageously be used for further productivity improving and job creating investments.

The weakness of the President's AMT reform proposal, which is to eliminate the depreciation adjustment in the Adjusted Current Earnings, (ACE) calculation, is that it applies only to property placed in service after January 1992.

Since most AMT paying firms have a large overhang of pre-1992 property, subject to the so-called ACE adjustment, the initial effects of the President's reform, as far as making more funds available for new capital investments, will be quite weak.

It could be improved considerably by making it applicable to all property now subject to the ACE depreciation adjustment.

The second of the President's investment incentive proposals is the temporary 15 percent Investment Tax Allowance (ITA). While somewhat helpful, it has two major design limitations: (1) its extremely limited 11-month duration and (2) the fact that due to the basis adjustment, it reflects solely a timing difference.

The way to improve this is fairly clear: First, make the ITA permanent, or at least, significantly extend its duration; and second, eliminate basis adjustments.

As a possible alternative to the ITA, we recommend that this Committee consider reinstatement of a permanent Investment Tax Credit (ITC) that is available against both the regular tax and the AMT.

History has shown the ITC, implemented without any incremental feature, to be the most powerful and efficient of all investment incentives. It generates greater dynamic revenue feedback than any other tax reduction showing an identical amount of static revenue loss; or to put it another way, the most "bang for the buck."

And its positive effects are impressive: Our analysis shows that after 6 years of a 10-percent ITC, annual Gross Domestic Product (GDP) is $120 billion higher and employment 1.6 million jobs higher than under current law.

Since time is limited, let me state briefly and without elaboration, the remaining points made in my prepared statement.

It is important to maintain fiscal discipline. No plan should be adopted which results in large increases in the Federal budget deficit. However, to achieve meaningful economic stimulus, we urge that tax cuts not be paid for by offsetting tax increases, but instead by spending reductions.

NAM supports making the R&D tax credit permanent. We also urge the Section 861 R&D allocation rules be made permanent rather than just extend it for another 18 months as proposed by the Administration.

Stable R&D tax provisions should be a top priority for improving competitiveness and growth.

NAM also supports a reduction on the rate of tax on capital gains. We believe this should be done without offsetting rate increases on ordinary income which would largely negate any economic stimulus.

We also believe simplification, especially of the excessively complex rules applicable to multi-national business operations of U.S. based companies, can definitely help improve global competitiveness. We, therefore, support S. 936, the Foreign Tax Simplification Act, as a significant first step toward this goal.

NAM supports repeal of the counterproductive luxury tax, not just on planes and boats as proposed by the Administration, but also on autos and all other items to which it applies.

We are in full agreement, conceptually, with the idea that Health Care Reform should not be founded either on employer mandates or on tax increases on either employers or employees.

It is also critical to avoid financing expanded access to health care by further shifting costs from the public to the private sector.

And finally, we are concerned that many of the plans being considered are out of balance. Permanent consumption oriented tax cuts will have but transitory effects on long term growth and competitiveness at a huge revenue cost.

NAM believes a much more productive and much less costly approach would be to offer permanent investment incentives and only temporary consumer tax cuts.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Motley, we are delighted you made it. It is nice to have you here.

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

STATEMENT OF JOHN J. MOTLEY III, VICE PRESIDENT FOR FEDERAL GOVERNMENTAL RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. MOTLEY. Thank you, Mr. Chairman.

Mr. Chairman, Senator Chafee, Senator Rockefeller, Senator Breaux, I am John Motley, vice president for government affairs for the National Federation of Independent Business.

On behalf of our more than 550,000 members across the country, I want to thank you for the opportunity to share our views on the Economic Development Package that you will be considering in this Committee, and personally, Mr. Chairman, let me state that it is

a pleasure to appear here again before this Committee. We have appeared so many times in the past. Thank you for inviting us.

In anticipation of this debate, NFIB in late December and early January did a random sample poll of 5,000 of our members to which we received over 1,000 responses, asking them whether or not they felt that Congress should engage in tax cuts at this time, what things you should do to help stimulate the economy, and if so, what taxes you should focus on and which ones you should not focus on.

It may surprise you to find out that our members were rather overwhelming in their desire that you focus on continuing to cut the deficit rather than on cutting their taxes.

They tend to believe—in another survey that we are going to be publishing soon—the number two problem out of 75 listed is Federal taxation so they tend to feel that they are over-taxed somewhat.

But even as such, 72 percent of them in this December/January poll said that you should focus on cutting the deficit and only 27 percent of them said that you should focus on cutting taxes.

While it is rather obvious to us that the tax cut effort is going to go forward probably no matter what the small business community of the country thinks, I would like to share with you what their choices would be if you are going to take action in this area.

They, like in 1986 and in 1981, remain focused on rates as their major issue, and that should not be surprising since two-thirds of all of the businesses who operate in this country operate as noncorporate entities. And very many of the corporate entities are closely held corporations, therefore personal income taxes and corporate rates are the most important thing to most of the small businesses this country.

If you were to provide large individual rate cuts or middle class tax cuts at this time it would be rather expensive, and likely the final outcome would be too small to have any real impact upon the economy.

Since you may not end up cutting individual rates, we would urge you very strongly then not to do the negative side of it and that would be to raise rates on the small business community. There is nothing that you could do that would hinder their attempts to come out of this recession more than to increase personal income tax rates at this point in time.

I cannot let the opportunity pass, Senator Bentsen, without commenting once again on what I think is a wonderful idea of Senator Moynihan's, and that is to cut FICA taxes.

We have one of the most regressive taxes in American history. It is a direct tax on jobs. It has risen dramatically over the last couple of decades and our membership would very much like to see it cut.

We believe that there is no quicker, more effective way to help both middle class Americans, because the tax is capped on the amount of income it's on, but also to help small business owners in the United States to reduce the cost of their labor than to consider a FICA tax cut. We still strongly support that idea and hope that the senator will go forward with it when the legislation reaches the floor.

In the area of investment incentives, let me simply say that we are consistent; simplicity is the key for the small business community. We prefer, above all other things, an increase in direct expensing. It is what our members would use most. It is at $10,000 now.

We believe that about 80 percent of our members invest less than $20,000 a year, so an increase to that level would take care of most of the investment needs of the small business community.

ITC would be our second choice, again because of its simplicity. In terms of the President's proposal, increasing allowable first year depreciation, it is probably the least preferred of the three choices that are out there.

Senator CHAFEE. What was the least preferred?

Mr. MOTLEY. The President's proposal to increase first year depreciation allowance, Senator Chafee.

Senator CHAFEE. Thank you.

Mr. MOTLEY. And that is only because it is a little bit more complex than the other two. Although certainly I think small business owners have gotten use to the tables now and could use them.

We do support a capital gains tax cut. We have always supported a capital gains tax cut. We support both the idea put forward by Senator Bumpers and the Administration's proposal. Of the two, we would prefer the Administration's proposal at this time, although we would, as I said, support either of them.

Let me conclude, Mr. Chairman, by saying that we believe that any action taken by this Committee to address the Nation's economic problem should be targeted, should be modest, and should take into account the huge size of the current budget deficit.

NFIB recommends that you reduce Federal spending wherever possible; reduce or simplify regulations, particularly for the small business community—you have before you a bill by Senator Baucus which would simplify those regulations in the area of payroll tax deposits—when one of our every three businesses in the United States is find and penalized by the IRS every year for missing a payroll tax deadline, it is something you should take a look at.

Try to cut the cost of labor. Senator Moynihan's proposal again. And of course cutting the cost of capital so that smaller firms can invest in those things that they have been putting decisions off on.

Probably the most important finding of NFIB's survey may be that 75 percent of those members who responded said that they would reinvest any tax cut that they received in their businesses.

If after these hearings you decide to cut taxes, NFIB strongly encourages you to take a look at the small business community: It did lead the way out of the recession in the eighties. It created a great number of the jobs in the 1980's. And we believe that if you target assistance in that area it will give you the greatest bang for the buck, because they will invest in America and American jobs.

Thank you, Mr. Chairman, and members of the Committee.

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

The CHAIRMAN. Well, thank you gentlemen. Thank you very much.

Let me say as one who started with a small business, I well understand the roll it plays in the American economy and the jobs it creates. I am deeply interested and concerned about it.

As I listened to this testimony, Mr. Cizik—and let me say to the rest of you—it is absolutely critical and essential, and I feel it very strongly, that we do not add to the deficit in what we do.

Now when you talk about cutting taxes, if we cut taxes, we are going to replace it either with other taxes or with cuts. What I have seen presented to us by the Administration really fudges that one.

When I see a situation like on PBGC and they go to accrual accounting and pick up $19 billion who are they kidding? That raises the deficit. No question about that. That is what we are being presented with.

I feel very strongly about R&D. I would like to extend it permanently. I like the investment tax credit. I like the Accelerated Depreciation. I like each and every one of them, but we also have to pay for it. And that is part of that limitation.

You fellows say, "Well, cut spending" but I didn't hear any of you specify where? We have to make that decision. You have to face up to that. And don't tell me to just cut waste. I have listened to that one. I have been here a while.

Give me specifics. That is what we have to decide. Fiscal discipline? Absolutely. I sure agree with that one.

Now let me give you one of the tough choices we will face, Mr. Gilbertson. I have got the problem of capital gains and I am the fellow that has supported cuts in capital gains for years.

As much as anyone on the Democratic side I lead that fight on this Committee; and led it along with Cliff Hansen who led it on the Republican side. Reducing the capital gains rate was a lot more important when the personal income tax was 70 and 50 percent. The locked position on assets was even more apparent then.

But the problem I run into is whether we lose or win money by it, in the way of revenue. I listened to the Reagan Administration argue in 1986 that if we would raise it from 20 to 28, we would pick up billions of dollars and help pay for the cut in the personal income tax.

Now I have listened to this Administration say, "If you lower it, you will pick up billions of dollars." Interesting business. How do you reconcile that? But that is what we are faced with.

Now let me give you a choice; the kind of thing we will have to do. If you were faced with the President's package on capital gains or you were faced with the one that Senator Bumpers has that is targeted; which one would you choose?

Mr. GILBERTSON. Okay. The American Electronics Association has clearly come out strongly behind the Bumpers Bill or the Enterprise Capital Formation Act for several reasons:

One is it does encourage—as my co-panelist pointed out, Mr. Motley—it encourages small businesses to start up, because it encouraged those people who are tax sensitive; the relatives, the friends, the small investors who produce 95 percent of all the money that starts these companies—not the venture capitalists—95 percent of the money comes from individuals and it induces them to take the risk.

The second reason is that the cost is extremely low: The cost, by the estimates we have seen, of the Enterprise Capital Formation Act over 5 years is less than $1 billion. It is somewhere between

$700 and $900 million; which, yes, there needs to be some offsetting revenue of $100 to $150 million a year, but it is not a massive number.

We do think a Capital Gains Tax Bill of any kind is necessary to encourage these investors to get out and start putting money in.

That chart was an attempt to show that every time we lowered the tax rate the investment went up. The dotted line is the tax rate—as you can see—when it comes down, the amount of money put into new ventures went up. And the minute we raised the tax rate, which we did in 1986 from 20 to 28, it went right back down again. It went from $4 billion to $1 billion.

The CHAIRMAN. I believe very much in that.

Mr. GILBERTSON. So we do believe that lower taxes are right and if the Reagan Administration in 1986 was who was behind raising the rate, that was wrong. I am not clear who the culprit was but the bottom line is that was wrong.

But to lower it and make a differential is key and we believe the Enterprise Capital Formation Act is an inexpensive way to do that.

The CHAIRMAN. All right. Let me ask you another question. I see by the time we have got a limitation on ourselves here too.

If you had the choice between the targeted capital gains tax cut, a broad-based cut, or increased capital loss relief by expanding section 1244. The law, as I recall now, says that for a small corporation; something under $1 million in capitalization, I believe it is, that you can charge off the losses in the amount of $50,000 a year against other income.

If you had that—that's for singles—and for married $100,000; what if you raised the capitalization to $10 million—because today a million dollars still sounds like a lot of money to me, but it is not much.

Mr. GILBERTSON. It does not do much.

The CHAIRMAN. It really doesn't. And when you think about the period of time that you have to carry that company until it finally makes a profit and that is usually maybe 8 or 10 years. How would you weigh that as an incentive if you raised it to a $10 million capitalization?

Mr. GILBERTSON. I think that would be a positive incentive particularly for the individual entrepreneur.

I believe the Bumpers Bill or the Enterprise Capital Formation Act would be more of an incentive for the other investors who are involved in it: those other who would probably make up at least half or three-quarters of that investment, so I guess it would favor the Bumpers Bill if we had to take a choice.

The CHAIRMAN. We have got questions for you two fellows too, but I have got to get on. I have a limitation of time. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. Thank you members of the panel for being with us.

As the Chairman indicated one of the biggest problems of capital gains has been "what's the result going to be" and no one can predict that.

Joint tax tells us a broad base capital gains tax reduction will generate or lose $12 billion while Treasury tells us—about the same bill—"no, it is going to generate $12 billion."

And so for those of us in Congress trying to figure out how we pay for something, if it costs a certain amount of money, we have our hands tied.

I think all of you are fairly familiar with my proposal which is a broad base proposal reducing capital gains for 25 percent, 22 percent and 20 percent based on the 3, 2, and 1-year holding periods. We try and break the log jam by setting up what I call a safety net; whereas we take a look at the effect of the capital gains reduction in the third and fourth year.

If it has raised revenue we declare ourselves a winner; more jobs are created, new businesses are created, and everybody wins. If, on the other hand, we lose revenues, as Joint Tax tells us a capital gains tax cut will do, then I create a fourth income tax rate and I have it at 36 percent.

The new bill, which we will introduce, will have a flexible rate. Depending on how much is lost the rate would be set to cover just that loss. It could be as low as 31 percent or 33 percent or what have you.

It is a contingent tax. And if it does what you gentlemen, I think, think it will do, the fourth rate would never come into play. If we are all wrong, we are not going to just add to the deficit. We are going to pay for it. And I would like to have your thoughts about that approach.

Mr. MOTLEY. Maybe I should try first because I have a pretty simple answer.

I don't think most people in the small business community would be willing to trade lower rates for a capital gains tax cut. All of the polls——

Senator BREAUX. Lower rates for a capital gains tax cut. They all would——

Mr. MOTLEY. I mean higher rates for a capital gains tax cut.

Senator BREAUX. I bet everyone of your members would take that.

Mr. MOTLEY. They certainly would. You know them as well as I do.

But all the polling that we have done on all of the questions——

Senator BREAUX. Well, let me ask you on that point; do you think a capital gains tax cut would increase revenues?

Mr. MOTLEY. Initially, yes, I think it would create additional economic activity. We have as much difficulty determining what the ultimate consequences are going to be in terms of revenue gain verses revenue losses as you in Congress do. I frankly don't know the answer to it.

I do think that we at NFIB believe that a cut would certainly generate increased economic activity and increase taxes in the short term.

Senator BREAUX. Then the fourth rate would never kick in. Do you think it would lose in out years?

Mr. MOTLEY. I can't answer that question.

Senator BREAUX. Mr. Gilbertson?

Mr. GILBERTSON. Well, as you know, when you ask that question to a group of venture capitalists, small investors and CEOs of high-tech companies, it is unanimous that it would not cost in the fourth year or fifth year out that there would be a net gain.

We do have some history too. From the Capital Gains Tax Bill of 1978, we do know that the amount of taxes received on capital gains rose from $9 billion to $46 billion over the course of the next 7 years. It consistently went up every year; $9 billion, $11 billion, $17 billion, and on up to $46 billion.

And we do know the minute we raised the rate it fell. It has fallen now to $35 billion last year and it probably will fall again this year.

So the net effect is—history says revenues will continue to increase—businessmen say they believe it will increase. So, yes, you have a—though no one wants a higher rate—the belief is that it would never kick in.

Senator BREAUX. Mr. Cizik?

Mr. CIZIK. Yes, Senator. I am not as well versed on the specific calculations of your proposal as you are obviously.

Generally speaking, I believe it would be NAM's position that it favors anything that would be a movement in the direction of putting some sort of a lower capital gains rate into effect.

Like my colleague on my right, I don't believe our members would favor increasing ordinary income rates to pay for that.

Senator BREAUX. Do you think a capital gains tax would generate revenues or lose revenues?

Mr. CIZIK. Again, everything I have read would indicate that in the short term it would generate revenues.

Senator BREAUX. There is now——

Mr. CIZIK. There is no debate about what it does over the longer term—in terms of increasing revenue. And personally in terms of the incentives that would come in and all that comes in to lower capital gains rates, I believe it would.

I think it is an aberration in our tax law, quite frankly, as we look around the world at other industrialized countries, other advanced countries, we are one of the few countries with a capital gains tax.

Senator BREAUX. Well, yes, the problem is what you are pointing out. We don't know what it is going to do in the out years.

Mr. CIZIK. Absolutely.

Senator BREAUX. As a result of that we don't do anything.

I mean, the Members of Congress make a very legitimate argument in saying that if we don't know what it is going to do we can't proceed forward with it.

And what I have attempted to do is say, "let's just don't sit on our hands while Rome is burning." Let's try it, but let's have a mechanism that would kick in on a contingent basis if it doesn't work so that we just don't raise the deficit and that we pay for it.

The fourth rate would effect only two-tenths of 1 percent of the American taxpayers; those making over a half a million dollars a year, which would never happen if, as I think we all feel, it generates revenues.

It is an attempt to break the log jam. I would appreciate your thoughts on it.

Mr. CIZIK. As I say, I haven't studied the details.

Senator BREAUX. Everybody wants it but everybody is fearful of a tax rate being kicked in. But all of you are telling me that you

are only going to raise revenues so you shouldn't have anything to worry about.

Mr. MOTLEY. I would suspect that in the out years if we found that it was losing revenue and there was an attempt to increase rates, it would probably open up a whole another debate and battle over whether that last step goes into effect or whether some other revenue sources are found.

Senator BREAUX. Oh, it would never go into effect, under my plan, unless we had lost revenues. Just like the old windfall profits tax that we didn't like—it was a contingent tax.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Gilbertson, I need some convincing on this capital gains and I have a feeling that you are right. We had the Secretary of Treasury up here yesterday and we talked about unlocking capital. I believe it does that.

But the trouble we get into around here is the argument that it might help the rich; which I think is a very unfortunate argument. I think the argument should focus on whether it is going to help create jobs.

If, while creating a lot of jobs, it incidently helps the rich, as far as I am concerned, that's all right. I'm interested in the job creation aspect.

In your testimony, it seems to me that you present a pretty good case that history indicates that when we have raised these rates, as we did in 1986—and I very enthusiastically supported that Tax Reform Bill of 1986—the result was a rather precipitous decline in venture capital. And I think that this argument of yours is a good one that merits serious consideration.

I am also interested in the statistics you cite in the middle of page 4 of your testimony about the kind of person who invests in venture capital: the "informal investor."—I really question those statistics that you've got.

You say these informal investors are citizens with median incomes of $90,000 who provide over 90 percent of the startup capital in small companies. Where did you get those from?

Mr. GILBERTSON. We have the data from Venture Economics which shows that of the $60 billion raised for ventures in 1988, for instance as an example, approximately $2.5 billion was from professional venture capital firms which are primarily funded by Pension Fund, so therefore, they are not taxable entities or they are minorly taxable entities.

The other $55.5 billion in——

Senator CHAFEE. Now what percentage of the total would that represent?

Mr. GILBERTSON. That would be almost 96 percent.

Senator CHAFEE. All right.

Mr. GILBERTSON. The other 96 percent or $55.5 billion came from individual investors—either the owner/entrepreneur himself, his relatives, friends or groups of small businessmen, in this study, turned out they averaged $90,000 in average income—who will take some of their money and put it into a risk pool together.

And, in fact, these are the kind of people that meet over coffee in a restaurant with a Venture Guide and say that's a good idea.

In fact, if you remember the ads for Compact Computer, that is how it started.

Senator CHAFEE. These companies would presumably not trade as securities?

Mr. GILBERTSON. No. And, in fact, like the American Electronic Association, over 78 percent of our 3,100 corporate members are not public.

Most of the companies we are talking about trying to influence are not currently public companies. These are companies that are private small partnerships or small groups of people who are trying to become bigger companies.

The CHAIRMAN. Mr. Motley.

Senator CHAFEE. Well, I am dazzled by this information—go ahead Mr. Chairman.

The CHAIRMAN. Mr. Motley apparently wants to speak up.

Senator CHAFEE. Yes.

Mr. MOTLEY. Senator Chafee, NFIB has just completed a study with American Express on the creation and growth of small businesses in which we took about 3,000 to 4,000 firms and we covered them for 4 years. And what we found out in the birth cycle is that most of them start with money that is either personal savings or borrowed from friends and relatives. The very last source of money are professional venture capitalists: The very last source.

Senator CHAFEE. Well, you know, this is very very important. Without glossing over the fact that $90,000 is, for most people in the United States of America, a lot of money, it is still true that people with $90,000 don't usually have extra money to spare to spend on investing.

Any followup material that you have on this from the AEA would be greatly appreciated, because this is, to me, very important. I am interested in the job creation aspect, and I think that a terrific argument can be that when you invest you are creating jobs, and people pay taxes, and thus the entire country can benefit.

I would like to ask Mr. Motley a quick question because my time will be up shortly.

I am surprised that you don't lay more accent, and maybe I'm barking up the wrong tree here, in the value of the ITC, which is a deduction from taxes, rather than the ITA which the Administration has recommended.

It seems to me that the ITA wouldn't mean much to your folks if they are incorporated because they are in such low brackets.

In other words, I figured out that in the first $100,000 of earnings, under our Corporate Tax Code, you are taxed at only 25¼ percent. And so, therefore, for most of your folks—I presume that they are not making more than $100,000 in a year—I wouldn't think that the ITA would amount to anything.

Mr. MOTLEY. Senator Chafee, maybe you misunderstood me. Our preference would, first of all, be direct expensing. The old Senator Packwood idea in 1986 is something that we would find most preferable.

Our second choice would be a reinstatement of the investment tax credit.

Our third choice would be the Administration's proposal. From a small business standpoint, it is one of simplicity and bottom line, and that would be the order that we would pursue.

The CHAIRMAN. Thank you.

Senator CHAFEE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Rockefeller, you have no questions I understand.

Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I would just like to thank our panel and obviously thank Mr. Motley for his statement about the Social Security Trust Funds.

I would just want to say to my colleagues that I don't know if we realize the development in the American public of the sense of genuine distrust and even alarm about what is going on.

There was an article in a New York newspaper just a little while ago about a mass mailing that begins, "The politicians in Washington have stolen the Social Security Trust Fund. That's right, every penny is gone." It was received by a citizen in Syracuse and it is signed by our former colleague Senator Murphy on behalf of the United Seniors Association.

It is a six page letter and it says, "send money and money." This journalist tried to find out more about it, but I can just say that there will be more who don't doubt that and one of the problems is that it is not entirely wrong, but there you are.

Mr. Motley, I thank you and I will return the subject. Thank you, gentlemen.

The CHAIRMAN. Gentlemen, thank you very much for your——

Senator CHAFEE. Could I can one quick question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator CHAFEE. It seems to me, Mr. Gilbertson, if I understand what they are proposing in the House, that they propose to apply a 14-year amortization to software. I imagine that this would cause you to really raise the alarm.

This is serious business. It would seem to me to be devastating as far as you folks are concerned. Am I exaggerating this?

Mr. GILBERTSON. For the 20 percent of our membership which is software companies it is devastating.

The average life of a software developed product before it is revised and upgraded is about 3 years. So if you, in any way, amortized the development costs or you acquire some software by acquiring another company or rights to a product, and have to write it off for 14 years, you will be expensing it for 11 years after you never sell it again.

And that is just very bad tax policy. You should be matching expenses with revenue.

Senator CHAFEE. Is this suggestion moving along or does the 14-year amortization make an exception for software?

Mr. GILBERTSON. We are actually trying to say that there should be an exception for software and it should be 3 or 4 years.

Senator CHAFEE. And there are probably a lot of other things that should be exceptions.

Mr. GILBERTSON. Unfortunately that introduces a lot of people saying that there should be exceptions, so we have a problem there.

The CHAIRMAN. Mr. Motley, did you want to make a comment on that?

Mr. MOTLEY. Senator, I just thought I would like to take a shot at your original question for a second on whether you would prefer the Administration's proposal or one similar to that drafted by Senator Bumpers.

And I think it really depends on your public policy goal. If you want to create, you know, broad economic activity, which obviously the Administration wants to do at this time and Senator Breaux proposal does, you would probably favor one drafted similar to the Administration.

If you wanted to focus though on creation of small businesses and creation of jobs, I think that Senator Bumpers' proposal does an admirable job in that area.

So I think really the choice is yours depending upon what you want the impact and the effect to be.

The CHAIRMAN. Well, I think there is something else that has to be added, Mr. Motley, and that is trying to stay within the limitations of the deficit——

Mr. MOTLEY. Yes.

The CHAIRMAN. And not try to expand it. What we are told about the difference in cost of the two plans, that is another element that we are faced with unfortunately.

Mr. MOTLEY. Obviously our members' first choice would be that you do as little as possible in terms of increasing the deficit.

The CHAIRMAN. That is right and I share that and I don't want to increase it any.

Senator Bradley, do you have any questions?

Senator BRADLEY. Mr. Chairman, I think I will not ask this panel questions. Maybe I will just ask them one.

Do you think that the thing that would help the economy more would be a reduction of the deficit or various tax incentives?

Mr. CIZIK. May I comment, please?

The CHAIRMAN. Yes, of course. Go ahead.

Mr. CIZIK. We certainly feel that it is important that we have long-term growth in our economy. We also feel that it is important that we do whatever is possible to increase the productivity of our country because it is important in terms of maintaining our standard of living and in being competitive around the world.

Now when it comes to matching up one or the other, quite frankly, you gentlemen are much much more conversant on the spending side of the budget, on the spending side of the government than I am.

But if you are asking me, "What can we do to improve the growth potential of this economy, and what can we do to improve the productivity of our economic tools, and insure that we can maintain, if not improve, our standard of living, vis-a-vis, competition around the world"—I think we need to do something to encourage investment.

We are a consumption oriented economy. We are not an investment oriented economy. On behalf of our members, we have 12,000 NAM members; manufacturers around the United States, small as well as large: this is what you could do for the economy—this is what you could do for the people of the United States.

Mr. GILBERTSON. Let me try to just——

Senator BRADLEY. If you could just try to be brief because I——

Mr. GILBERTSON. I will be very brief. The bottom line is that we need to make the pie bigger which will generate more tax revenues. And the way we make the pie bigger is by investments.

So, therefore, we believe a capital gains tax cut, an R&D Credit, and the 861 Relief are absolutely essential to make the pie bigger. Because small companies create jobs. They created 18,000 million jobs in the 1980's.

Senator BRADLEY. These measures would be more important than reducing the deficit?

Mr. GILBERTSON. Yes.

The CHAIRMAN. Thank you very much, Mr. Gilberston. I'm sorry, you hadn't finished. Go right ahead.

Mr. MOTLEY. Our members feel that there is very little that the government can do right now to bring us out of the recession in the short-term and would focus on the deficit rather than cutting taxes.

Senator BRADLEY. You prefer to focus on the deficit?

Mr. MOTLEY. Yes, sir.

Senator BRADLEY. So (1) proposes to focus on the deficit; and, (2) proposes to focus on investment incentives. Thank you.

Mr. MOTLEY. But Senator Moynihan proposes——

The CHAIRMAN. Let me—please—Mr. Cizik, I couldn't agree with you more about our being a consumption oriented society and not an investment society.

We have to turn that around. We have to increase savings in this country. We have to develop the capital in order that we can have plants that average the same sort of age that some of our major competitors like the Japanese: their plants average 10 years of age; ours averages 17 years of age. They are saving three times as much as we are. The West Germans twice as much. We have to turn that around.

But let me also tell you one of the problems. What brought us the alternative minimum tax on corporations? If you think back to 1986, you will remember a widely cited study of over 100 major corporations in America. These corporations were reporting to their stockholders that they were making hundreds and hundreds of millions of dollars and yet they were paying no corporate income tax.

Perception is important when you are talking about taxes. People have to believe that it is fair. When the system loses its credibility, then people don't pay taxes. So that is part of what we are faced with.

At the same time, I understand too that the minimum tax is having some unintended effects and is particularly hard on capital intensive companies. We have to try and figure our way around that and see what we can do and still not get back to the kind of situation we had before.

Mr. CIZIK. May I comment, Senator?

The CHAIRMAN. All right. Certainly.

Mr. CIZIK. I understand. There were certainly distortions in equities which the Alternative Minimum Tax was designed to cure. But unfortunately it was a blunderbuss being used, and I cannot believe that the Congress intended to deprive corporations of a deduction for depreciation.

The CHAIRMAN. No. No. I agree.

Mr. CIZIK. That is just natural. The whole ACE method is an inequity that needs to be cured. Further, I believe we do need some positive incentives.

Some slight variations of what the President has proposed: The ITA in eliminating the depreciation adjustment, for example, makes that a more meaningful incentive. An extension of time by just 1 year would make that. We are now asked to make decisions in 11 months to get the advantage of that, and that is not enough time.

The CHAIRMAN. Well, let me tell you one thing that concerns me. You said a "blunderbuss" was used. That is what worries me about this schedule we are talking about right now.

The President says that he wants it by March 20th. We are talking about things of incredible magnitude as to how it affects the economy.

We have an economy that is dead on the water. I want to be sure that we are right.

Mr. CIZIK. Absolutely.

The CHAIRMAN. That we do not mess up on the process. Thank you very much, gentlemen. We have several more witnesses here.

Our next panel is Dr. Fisher who is the Director of the Bureau of Economic Geology, University of Texas. Dr. Fisher is an old friend of mine and one that is quite an authority on production and dependence on energy in this country.

Mr. Ames is the Chairman of the Independent Petroleum Association of America.

Mr. Dorcas Helfant who is the President of the National Association of Realtors. If I have mispronounced your name, please correct me.

And Mr. Steven Wechsler who is the President of the National Realty Committee.

Mr. Thomas Bloch who is the President and Chief Operating Officer of H&R Block, Kansas City, MO.

When they talk about investors in small companies—start-up companies—I still regret the time I didn't invest in your company when I was offered a chance to at the beginning of it.

Now with that in mind, Dr. Fisher, why don't you lead off?

STATEMENT OF WILLIAM L. FISHER, Ph.D., DIRECTOR, BUREAU OF ECONOMIC GEOLOGY, UNIVERSITY OF TEXAS, AUSTIN, TX

Dr. FISHER. Mr. Chairman and members, thank you. There is a common view that the U.S. energy production capacity is one that is bound to decline over the long term. There are some problems in our abilities in the energy area, but I think the fundamentals are really quite good.

There are some steps that we need to take. They are not, in my judgment, herculean, but they definitely need to be positive. I have summarized some of those in my statement and they include specifically some modifications of the Tax Code that would be very helpful in trying to assure long-term stabilization of oil production in this country and the ability to increase natural gas production.

I say the fundamentals are pretty good because on the face of it there is some fairly positive things about the energy situation today.

We have got prices that are as low for oil and natural gas as we have seen in the last couple of decades; that has a very positive contribution currently to the economy. There might however, be some very fundamental costs in the long return that will hurt in that regard.

We are seeing some stabilization of production in the case of oil in the lower 48; much lower than what it use to be, but our ability to add reserves is still pretty good. That will slip if we do not take the steps to maintain it.

We have made some very substantial strides, it seems to me, in conservation over the last couple of decades—in terms of how we use energy; and particularly, most of that has come in greater efficiencies in the use of oil and natural gas.

We have seen, particularly, in the areas of efficiencies in our ability to add reserves, a substantial improvement over the last decade.

The volume at which we add oil and gas per operating rig in the United States now is about 2½ times what it was at the beginning of the decade.

Those are all very positive things. At the same time, there are a lot of negative elements that are moving forward.

Natural gas prices are so low that it is hard to sustain and we are beginning to see a slip in the rig count now. We are seeing a lot of the major companies exporting their exploration of expenditure abroad, and as a result, unless we make a move to secure our production capacity, it will slip away and we will lose it.

There are several things that can be done. I will not go through all of them, but I will briefly mention that we need to get to some stabilization of price; that uncertainty has created a tremendous amount of discounting in our effort to drill in this country.

We need to think in terms of access. We may have some very good motives for keeping exploratory promising areas off limits, but that is not consistent in any way with maintaining production capacity.

And then specifically in the area of the Tax Code. What we need to be addressing, I think, is the Alternative Minimum Tax. Mr. Ames will be talking to that very specifically, but that has the effect of capping a lot of the activity amongst the independent operators in this country, and of course, they are the backbone of what we do in the way of oil and natural gas production.

I think further in the Tax Code, and this may be beyond what you can accomplish in the next few days—or a March 20th deadline or the like—but one thing we ought to keep our eye on in our ability to maintain productive capacity in this country is the point that our future capability is technologically dependent.

The old days when we could count on economy of scale the giant field discoveries or the kind of things that OPEC now has, we no longer have.

The economies that we have now are the economies of efficiency; they become the economies of technology. And in that particular re-

gard there are some things that we can do to really encourage technologic applications.

This Congress had passed, just a couple of years ago, incentives for extraction technologies; so-called (EOR) where you could expense items that you would use for the enhanced oil recovery.

Most of the oil that we can probably add in the near and the mid-term is really not as amenable to those kinds of technologies as it is to technologies that would allow a recovery of conventionally movable oil from very complex reservoirs.

If you could extend those EOR credits to, what I call, geophysical detection technologies—there is a whole range of those things—that would better allow us to drill with greater amounts of efficiencies, that would make a tremendous boost in what we could do, particularly in oil recovery and also in natural gas to an increasing intent.

So those are two provisions really basically out of the Tax Code that I would urge strong consideration: AMT and an extension of tax credits that are specifically geared to the kind of things that offer the best opportunity in enlarging and maintaining production capacity. Thank you, sir.

The CHAIRMAN. Thank you.

Do you have the specifics of that in your statement?

Dr. FISHER. Yes, sir. They are spelled out in the attachment. There are a whole series of things that would encompass those.

The CHAIRMAN. I look forward to reading those.

Dr. FISHER. Yes, sir.

The CHAIRMAN. Mr. Ames is the Chairman of the Independent Petroleum Association of America. Mr. Ames, we are pleased to have you.

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

STATEMENT OF EUGENE L. AMES, JR., CHAIRMAN, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. AMES. Thank you, Mr. Chairman. As Chairman of the Independent Petroleum Association of America, I represent 45 state and regional natural gas and oil producer associations.

Together with IPAA, we represent virtually all of America's independent natural gas and oil producers who produce 60 percent of the natural gas produced in this country and 40 percent of the oil in the lower 48 states.

I appreciate the opportunity to appear today before you, but let me get right to the bottom line: Our domestic oil and gas industry is collapsing.

In the last 10 years, the ranks of the independent producers who drill 80 percent of the exploratory wells has been cut by nearly two-thirds. We have lost more than 317,000 good paying United States jobs in the oil and gas extraction industry. Three times the number of jobs lost in the automobile industry.

Last year the active drilling rig count, which is the barometer of industry activity, was at the lowest level since 1942: Just two weeks ago it crashed to 653 rigs; the lowest number of active rigs in recorded history.

There is not enough drilling now to support our industry's infrastructure. And as Dr. Fisher indicated without the drilling level being increased, we cannot maintain stable oil production—domestic oil and natural gas production.

Our domestic oil and gas production is destined to decline much faster than estimated and oil imports will inevitably be much more than projected if we do not jump start our oil and gas industry in this country.

Since 1985, 1.6 million barrels a day of United States crude oil output has been lost; roughly equivalent to Kuwait's total output before the invasion.

Today imported oil costs us $146 million each day and that is money we are sending to the Saudi's and their OPEC colleagues.

The cost of oil imports accounts for half of the United States trade deficit, and using the Office of Technology Assessments' import forecast, with the Department of Energy's price forecast, our imports will triple to $138 billion a year over the next 8 years, if present trends continue and our present depressed condition of the domestic oil and gas industry is allowed to continue.

The people who work in America's gas and oil fields deserve to be part of the economic growth package. The independent oil and natural gas industry is not asking for any new tax incentives.

We simply urge you to remove the Alternative Minimum Tax Penalties on producers who reinvest their oil and gas income to hire people to drill new wells.

This country has a vast endowment of undeveloped oil and gas resources and we can stabilize, and even increase oil production, if we drill more wells.

Let me turn to the specific Alternative Minimum Tax problem: Like all other businesses, independent producers are subject to the accelerated depreciation preference. But independent producers are singled out for special treatment under the Alternative Minimum Tax because a large portion of our drilling costs and percentage depletion are often non-deductible in calculating the Alternative Minimum Tax.

These drilling costs are just like the fully deductible ordinary and necessary business deductions in other businesses.

In fact, the Alternative Minimum Tax in reality is a tax on our expenses and the more we spend on drilling the more tax we pay; so we have stopped drilling.

Let's look at an example of how the Alternative Minimum Tax affects independents compared to other businesses that can fully deduct their ordinary and necessary expenses.

As shown on Charts 1 and 2 in front of you, the Alternative Minimum Tax penalty increases both the amount of tax and the effective rate of tax imposed on domestic producers, to amounts well in excess of other businesses whose expenses are not preference items. Last year one of my associates had an effective tax rate of 125 percent of his ordinary income.

Chart 3 shows that once a producer is in the Alternative Minimum Tax there is virtually no tax benefit or incentive to invest another dollar in exploring for oil or natural gas: And to repeat, we have stopped drilling.

This Alternative Minimum Tax cap on domestic drilling reduced the number of wells drilled by the industry from 17 to 25 percent according to a recent survey of independent producers.

Even more significantly, this amount of drilling is reduced further by the withdrawal of outside investment capital from this industry because of the Alternative Minimum Tax.

Our survey also shows that as many as half of the independents, not in the Alternative Minimum Tax, are carefully limiting drilling to specifically avoid the tax. Fewer wells drilled mean fewer jobs.

The CHAIRMAN. Mr. Ames, I will have to ask you to summarize so we have time for the questions.

Mr. AMES. Mr. Chairman, the Alternative Minimum Tax represents a sentence of capital punishment for the independent domestic natural gas and oil producer.

A revitalized domestic petroleum industry could create more than 100,000 jobs and could save our 460,000 stripper wells in this country which collectively produce over 100 million barrels of oil and contain tremendous reserves.

With reform of the Alternative Minimum Tax—the elimination of tax penalties on drilling and depletion—American's vast remaining reserves of natural gas can be developed, and we can reduce our oil imports to volumes which will be much easier to handle and will help save and protect the financial system of the United States.

The CHAIRMAN. Thank you very much, Mr. Ames.

Mr. AMES. Thank you very much, Mr. Chairman.

The CHAIRMAN. Ms. Helfant. I may be mispronouncing that. You correct me.

Ms. HELFANT. That is correct.

The CHAIRMAN. All right. Thank you.

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

STATEMENT OF DORCAS T. HELFANT, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Ms. HELFANT. Thank you, Mr. Chairman. Thank you, members of the Committee.

On behalf of the National Association of Realtors, which I serve as its 1992 President, my name is Dorcas Helfant, and I practice and have a real estate brokerage in Virginia Beach, VA.

Our 760,000 Members are acutely aware and concerned of the activities of these Committee. We are in the real estate business. Our business is bleeding and we are looking for relief, not an artificial stimulant, but just good healthy antibiotics to get the real estate business back on its feet.

The President stated what we believe is true: real estate can lead the Nation of our recession. And while we believe that his heart is in the right place, we believe that the President's proposals, when reading the fine print, could actually further undermine the real estate market.

The National Association of Realtors did not join with other groups in endorsing the President's plan. In fact, we oppose some of its features, even though we note with interest, that parts of the President's proposals are actually the best parts of legislation that are currently before this Committee and in other bills that have been offered by Members of the Senate.

We believe that nine members of this Committee have already cosponsored a Real Estate Industry Back Bill to provide relief in the passive loss area: (Senate Bill 1257).

And even Senator Packwood, the Guru of what we consider Passive Loss Treatment in 1986, has said that perhaps it went too far.

A huge majority of the Senate has cosponsored the Bentsen-Roth Bill: (Senate 612). We believe that that is good news for first home buyers in this country today.

And there appears to be bipartisan support for bills that extend mortgage revenue bonds, mortgage credit certificates, and low-income housing credits so that those Americans who need housing most will have the opportunity to explore it and realize their dreams.

I would like to address Passive Loss first. We note explicitly that the President's proposal is unacceptable and we oppose it in its current form.

Before the ink was dry on the 1986 Tax Reform Act, the real estate industry began its effort to secure relief from these unfair rules. Chairman Bentsen's efforts during that time in those final deliberations had our full support.

Today Senators Boren and Symms have introduced S. 1257. As I said, with nine cosponsors and with more than 40 Senator sponsors to remedy the situation and put real estate back on the level playing field.

Senate 1257 builds from the known framework of the material participation test, and relies on existing Treasury regulations. The President's scheme is completely inadequate and while it may benefit some individuals, it would not address the systematic weakness. Only S. 1257 addresses that.

Another aspect of existing regulations is indeed important and that rule permits property owners today to make certain elections on how they treat their property for tax purposes. It is important to retain that existing regulation; that's a fairness issue.

Another area is that S. 1257 relies on existing Treasury regulations. The bottom line is the President's proposals tells Treasury to start all over again.

It took Treasury 3 years and 400 pages to come to current issues so that those of us in the real estate business can file our taxes. Our business doesn't have another 3 years to muddle while Treasury decides what it wants to do with new legislation. We are very concerned about all those issues.

We are hopeful that S. 1257 will provide some relief also to the credit crunch as it applies to existing financing by freeing up cash flow for material participants and relieving some pressures on individuals still carrying troubled properties.

Oddly, the President's proposal would, if we didn't have a credit crunch, actually stimulate construction because it provides passive relief only for those properties developed by the taxpayer.

We are not asking for funds for new commercial property. We believe we have got in most of our markets an adequate supply. We just want to keep it in process, keep it in action, allow the private sector to, indeed, play its role in the economy and carry these properties under fair and equitable tax rules.

Also some of those folks might be willing to take some of that Government owned property; that's an important one to us too—treat them fairly.

If we had the best of all worlds, we would say let us have passive loss and capital gains with fair recapture under existing law; recapture on depreciation.

The President's proposal doesn't do this. It actually puts us in a worse position today than we have on current law. But to free up equity, allow properties to be sold in reasonable terms in today's market, we support a meaningful capital gains bill and we would appreciate your support on that.

The President's proposed change to the recapture rules is, in effect, also a change to tax principles that have been settled for 30 years. It works; why muck it up.

The last area I am going to mention is housing affordability. Those of us out in the real estate field understand housing affordability. We understand that the dreams of young families are out of reach today. Let us not be a nation of the housed and underhoused. Let us make sure that those programs, including the $5,000 Tax Credit, are made available to first home buyers.

Thank you.

The CHAIRMAN. Thank you very much, Ms. Helfant.

Mr. Steven Wechsler, the President of the National Realty Committee. If you would proceed, please.

[The prepared statement of Ms. Helfant appears in the appendix.]

STATEMENT OF STEVEN A. WECHSLER, PRESIDENT, NATIONAL REALTY COMMITTEE, WASHINGTON, DC

Mr. WECHSLER. Mr. Chairman, members of the Committee, good morning.

NRC, as many of you know, serves as Real Estate's Round Table in Washington, where we focus full time on national policies effecting taxes, capital, credit and the environment.

Our members are America's leading real estate owners, advisors, builders, investors, lenders and managers.

In 1981, National Realty Committee was invited to testify before this Committee, then engaged in a similar effort to examine the Tax Code with an eye toward restoring growth to the national economy.

While we certainly shared the view then and do today that overall economic growth is an urgent aim requiring immediate action by Congress, we said then that special tax incentives were not necessary to insure the construction of office buildings, hotels, warehouses and shopping centers the Nation required.

Frankly, we said in our testimony, "we are concerned if excessive tax incentives are offered for the construction of non-residential buildings, the inevitable result will be a boom in tax shelter motivated investment followed by the inevitable bust resulting from uneconomic over-pricing or over-production."

Unfortunately, our concern was all to prophetic, as the 15 year accelerated depreciation adopted that year helped fuel the wave of tax shelter motivated investment our industry experienced over the next 5 years.

In 1986, Mr. Chairman, National Realty Committee again spoke out for a rational tax policy for real estate. We applauded the concept of tax reform and the need to eliminate non-economic abusive tax shelters, but we vociferously opposed the passive loss provisions which over-reacted in the extreme to the tax sheltering unleashed in 1981.

The rules went so far as to brand all rental real estate activities as passive, regardless of how much time or effort one spends actively involved in the real estate business.

If you understand our views on tax policy today, our views in 1981 and 1986 should come as no surprise; that is because we try to take a long range approach to policy making at the national level.

Our views on tax policy and other matters are, in fact, grounded in our commitment to the long range health of the real estate economy and the national economy.

So pervasive and fundamental is real estate to the way we live that many often take this important national resource for granted. Fortunately, that's not the case today with President Bush and many members of Congress.

Two weeks ago, in the President's State of the Union address and budget, he signaled his recognition of the vital role real estate plays in our Nation's economy. The President offered a set of critically important tax initiatives aimed at stabilizing commercial real estate markets, facilitating homeownership, and encouraging necessary new home construction—all important goals if real estate markets are to recover and help lift the nation out of recession, as it has so often in the past.

Needless to say, many members of Congress and this Committee have made—and are making—the same points as well, underlining the linkage between a strong real estate sector and the health of the overall economy.

As the past 18 months have dramatized, when real estate suffers, so do people and businesses in all walks of life. And that's what's happening now. Real estate is in trouble—as are the banks—other financial intermediaries—and the economy.

Capital and credit are virtually non-existent—even for existing assets. Property values remain in free fall. State and local tax revenues are drying up. And, from our point of view, whether we've yet hit bottom is highly questionable.

It would be unfair to say that unsound tax policies alone are responsible for today's real estate crisis. They are not. But what is clear is that a combination of flawed national policies and poor business judgments are at the root of today's problems.

We appreciate the opportunity to offer our views today.

In short, our view is that a long-term, rational tax agenda for real estate is necessary to restore stability to today's highly volatile real estate market. Unless and until real estate is on a sound economic footing grounded in sensible and fair tax policies, we believe a meaningful national economic recovery is unlikely.

We are not endorsing a return to the tax sheltering of the 1980's. The initiatives that we have laid out for you today don't do that. We think other rules adopted in 1984 and 1986 provide an incredibly effective backstop to tax sheltering.

Likewise, the legislation we support would not reignite a speculative real estate development boom—new commercial construction, in large measure, is neither needed or desirable.

We offer the following recommendations: First, we agree with President Bush and the majority of the members of this Committee that the passive loss rules should be modified.

Senator MOYNIHAN. Mr. Wechsler, could I just say that we are in no hurry any longer and you just go ahead and finish your—I am afraid you're only going to——[Laughter.]

I'm the only listener you have, but note that you have very attentive people on either side. They will end up making these decisions not——

Mr. WECHSLER. Senator Moynihan, I look forward to not only working with you but all of those people over the next several weeks.

Senator MOYNIHAN. Go right ahead, sir.

Mr. WECHSLER. As I said, we agree with President Bush and many members of this Committee and the Senate and the House that the passive loss rule should be modified.

Congress should adopt S. 1257 which was introduced by Senators Boren, Symms, and Breaux. This legislation has over 40 Senate cosponsors.

It would modify the passive loss rules so that individuals engaged in real estate are treated the same as people in other business by allowing them to currently deduct losses from rental real estate activities in which they materially participate.

We are extremely encouraged that the President has recommended action in this critical area and believe his passive loss proposal is an important step forward.

Second, we agree with President Bush and many members of Congress that the capital gains tax should be reduced, but we completely disagree with the Administration's related proposal to repeal the depreciation recapture rules for real estate—the rules that have existed for more than 30 years.

Because only the gain in excess of all prior depreciation deductions would qualify for a lower capital gains tax under this approach, the effect on an owner selling property for the same amount for which it was purchased would be an 11 percent increase over current law.

This astounding tax increase could not be proposed at a worse time for the real estate industry or the economy—a time when values are substantially depressed and many sales are below, at, or just above cost. Congress should lower the capital gains tax and retain the current depreciation recapture rules.

We also agree with President Bush and many members of this Committee that tax rules should be modified to facilitate prudent pension investment in real estate. Several tax and regulatory policies create unnecessary obstacles to such investment. Without undermining protection against undue risk already in place, several rule changes should be made.

In particular, REIT ownership restrictions should be modified to permit domestic pension funds to invest in real estate through REITs on terms equal to foreign funds. This should be done by amending the "five or fewer" rule.

We also believe the existing secondary market for real estate debt and equity should be made stronger and more attractive. One of the most important changes in this area would be to allow subordinated interests in investment trusts to be tradable.

The Low Income Housing Tax Credit certainly should be extended as proposed, if not made permanent.

And tax rules that unnecessarily penalize real estate debt restructuring or workouts should be adopted. In particular, H.R. 3651 should be approved.

And finally, we believe that depreciation rules should recognize the true economic life of leasehold improvements. Today leasehold improvements in buildings can be depreciated over 31.5 years, the life of a building, even though they may be only in for a 5-year period and the term of the lease is 5 years. It is absolutely uneconomic treatment.

And finally, in 1987——

Senator MOYNIHAN. That is two "finale's," Mr. Wechsler.

Mr. WECHSLER. I'm allowed two? No more.

Finally, the "at-risk" rules should be modified to permit lenders, as this Committee approved in 1987, to provide seller financing without penalty to the buyers, particularly in today's environment.

In conclusion, we believe that our views, both in 1981 and in 1986, reflected a responsible outlook and we believe our views today are similarly reasonable and responsive. And hope that the Committee agrees as well as those important people behind you.

Senator MOYNIHAN. Thank you, Mr. Wechsler.

And now, Mr. Bloch, you're the anchor man here and we welcome you.

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

STATEMENT OF THOMAS M. BLOCH, PRESIDENT AND CHIEF OPERATING OFFICER, H&R BLOCK, INC., KANSAS CITY, MO

Mr. BLOCH. Thank you, Mr. Chairman, for the opportunity to present H&R——

Senator MOYNIHAN. May I just first say that Senator Bentsen had to leave. He has to be elsewhere in the country. It was only the flying conditions that required him to depart.

Mr. BLOCH. I understand.

Senator MOYNIHAN. But his people are here, attentive and listening to it all. And he still does regret not having invested in H&R Block.

Mr. BLOCH. Very good. [Laughter.]

Well, it may not be too late to do that.

Thank you for the opportunity, Mr. Chairman, to present H&R Block's views on the tax burden of middle income taxpayers.

We are the largest tax preparation service in the country. Last year we prepared over 12 million individual tax returns which represents about 11.7 percent of all U.S. tax returns.

We have more experience dealing with, and listening to, middle income taxpayers than anyone else.

Before addressing the need for middle income tax relief, I would like to talk about the recent change to lower the withholding rates.

In the State of the Union address President Bush announced that one of the keystones of his economic recovery proposal was to lower the withholding rates so that taxpayers will have less withheld from their paychecks this year. This is not a tax cut, but merely puts a few extra dollars into taxpayers' pockets now rather than having them receive a lump sum refund next spring.

Under the new tables, single taxpayers will receive on average an additional $3.00 per week in—

Senator MOYNIHAN. Okay. Could I just ask——

Mr. BLOCH. Yes.

Senator MOYNIHAN. Are the tables out now?

Mr. BLOCH. The tables are out now.

Senator MOYNIHAN. They are out?

Mr. BLOCH. Yes. Married——

Senator MOYNIHAN. The President doesn't normally get things like that done inside of 9 months.

Mr. BLOCH. It was awfully quick wasn't it? Married taxpayers who both work and file jointly will have $690 reduced from their refunds next year. Since the average refund is about $900, we know that many taxpayers will be shocked to discover next year their refund is substantially lower, and in some cases, eliminated.

Senator MOYNIHAN. Could you help us on that. I know Senator Chafee would be interested as well.

When you say the average refund is about $900——

Mr. BLOCH. Right.

Senator MOYNIHAN. And that's the people who go through H&R—are those your clients or——

Mr. BLOCH. That's—I am talking about the universe; the total universe—all taxpayers.

Senator MOYNIHAN. Get on average $900?

Mr. BLOCH. Over $900. Yes.

Senator MOYNIHAN. Why do I never get $900?

Mr. BLOCH. Well, that's——

Senator MOYNIHAN. Not average?

Mr. BLOCH [continuing]. Tax planning——

Senator MOYNIHAN. I don't—well—so it's what you know and the people you meet. That refund is a kind of a—that's why you buy a—you buy something with $900.

Mr. BLOCH. It is forced savings.

Senator MOYNIHAN. And most people, I assume, know about it.

Mr. BLOCH. That's about right. In fact, over—about 70 percent of all taxpayers do get a refund.

Senator MOYNIHAN. Yes.

Mr. BLOCH. And it is their preferred savings program.

Senator MOYNIHAN. That's the point I'd like to make. This is very important to me. Can you tell us your professional experience—that taxpayers know they are over withholding.

Mr. BLOCH. Absolutely.

Senator MOYNIHAN. But they know that it is a form of saving. It just doesn't seem to require anything and then you do get a lump sum, and you can think, well, I'll paint the—I'll put a roof on the garage with that.

Mr. BLOCH. Right. Exactly.

Senator MOYNIHAN. Yes.

Mr. BLOCH. That is what taxpayers want. It is what taxpayers expect, and I think if they find next year that that $900 or so refund isn't there, they are going to be shocked—really shocked and very very disappointed.

Senator MOYNIHAN. And there is another fact which is a small matter—but which is not so small—the Government gets a $15 billion float then.

Mr. BLOCH. Correct. That is true.

The other points I was going to make on this are the additional paperwork burden and, as you mentioned, the additional cost of this program.

Taxpayers have always had the choice of filing what is called a "W4 Form" to revise their withholding, but the fact is most taxpayers did not chose to do that. That's because they do want that big refund.

So now, because of this new decision by the President, taxpayers who want to keep their withholding at the current level have got to file a new W4 Form with their employer.

Senator MOYNIHAN. Oh, they have to go, as it were, to the Treasury and say—or their employer——

Mr. BLOCH. To their employer.

Senator MOYNIHAN. And don't do what—well.

Mr. BLOCH. Exactly right. So it is an additional tax burden for the taxpayer and for employers.

The other point too is that it could cause some compliance problems. Taxpayers are more inclined to file a tax return if they know they are getting a refund.

There are some taxpayers that may not file a tax return next year if they feel or know that they are not going to get a refund but, in fact, have to pay money. And that means the IRS is going to have to identify these people and locate these people. That is an additional cost and work load. I guess the——

Senator CHAFEE. But I may be misunderstanding here. I'm at the top of page 2 of your testimony here.

Mr. BLOCH. Yes.

Senator CHAFEE. You're saying that if the withholding is reduced and their average paycheck goes up $3.00 a week, it means that they will get less of a refund.

Mr. BLOCH. Correct.

Senator CHAFEE. And you imply that that's unfair.

Mr. BLOCH. Terribly.

Senator CHAFEE. Well, are you suggesting that you want them to get both? Do you want them to get——

Mr. BLOCH. No. No.

Senator CHAFEE [continuing]. The lesser withholding plus the refund? I mean, obviously they cannot get both.

Mr. BLOCH. No. I think the point is, Senator, that taxpayers should have the choice. They should determine they would like to get the money now or they would prefer to get the bigger refund. We know, based on our experience, that people prefer to get the bigger refund, because people have a tendency to just spend that extra $3.00 a week.

Senator CHAFEE. Oh, I see. The United States is sort of a savings bank for them.

Mr. BLOCH. Exactly.

Senator CHAFEE. But the President's belief is that in making withholding more accurate, i.e. by not withholding more than is necessary, then it is better for the economy. I suppose if you followed your thesis through, we ought to withhold a lot more——

Mr. BLOCH. I think it is a——

Senator CHAFEE. And then they'll get a whopping refund.

Mr. BLOCH. I think the point is let the taxpayer chose. Let the taxpayer chose.

Senator CHAFEE. Well, the taxpayer may choose. If the taxpayer wants to go in and reduce the number of exemptions with his employer, he or she can do so.

Mr. BLOCH. The President's decision requires now that those individuals who want to keep their refund where it is to go fill out one of these new forms. It is a little bit complicated. They have to deliver this to their employer. They've had the choice for years to change their withholding.

The fact is they didn't do it because they want the big refunds. So why should the Government decide—let's reduce their refunds; let's give them more money now.

Why not ask the taxpayer, "Is this what you want? If it is, we will do it for you." But this was an automatic program. Nobody was asked. It takes the taxpayer to go and find one of these forms, fill it out and give it to his employer.

Senator CHAFEE. Well, I think that it would help to have a better system than having taxpayers rely on the Federal Government to be their savings bank.

Mr. BLOCH. Well, I think the choice should be the taxpayers, and the fact is somebody could, yes, argue that "boy, you're not earning interest on this money." But the fact is this is how taxpayers prefer to save.

Senator CHAFEE. Does H&R Block make loans against any of these refunds?

Mr. BLOCH. We work with banks that make loans against refunds at taxpayers choosing.

Senator CHAFEE. Now I'm not trying to be too tough on you, but don't you have a little conflict of interest here?

Mr. BLOCH. I think really we are looking out for our customers.

Senator CHAFEE. You are not looking out for H&R Block?

Mr. BLOCH. And it's not just H&R Block. I mean, about 70 percent of all taxpayers get a refund.

Senator MOYNIHAN. If you were looking after H&R Block, you'd be the first witness in the history of the Senate Finance Committee to represent the interests of your own industry. [Laughter.]

So you have a chance to make history. [Laughter.]

Mr. BLOCH. Thank you for that opportunity, Senator.

Well, I have sort of gotten off my prepared statement, but I will point out——

Senator CHAFEE. So what you are saying, if I understand it, is that there has always been a system in place whereby the employee could go to the employer and by juggling around the number of exemptions could have more or less withheld from his paycheck.

Mr. BLOCH. Right.

Senator CHAFEE. In other words, if an employee wanted a lot withheld and he has four children, he could just tell the employer, "Forget those four children for now so that at the end of the year I will have a nice big check coming."

Mr. BLOCH. Right.

Senator CHAFEE. And now what you are saying is that the President has eliminated that—or else made it much more complicated for the employee to go in and have his exemptions reduced so that the withholding will be greater. Is that correct?

Mr. BLOCH. Right.

Senator MOYNIHAN. If the—on the—Dr. Fisher will agree or recognize the proposition that the data is the plural of antidote, and just simply when we were raising a family about half the people who were just our contemporaries, you know, would not take any deductions for the children, but then at the end of the year there was $1,500 or whatever, and that's the way they saved. It was the——

Mr. BLOCH. And what we are finding right now, in our offices during this busy time of the tax season, is that our customers aren't even aware this is happening to them. And of course, we're the ones who are going to have to bear the bad news next spring when people are going to come in expecting that $1,000 refund, and we say, "I'm sorry, the President made a decision last year and that means you are only going to get $280 or whatever it is." We have to tell the customer that.

And the problem is many people, I think, have got that money spent before they even get it. They know exactly where that money is going to go, and it is just going to be such a shock to them.

Senator CHAFEE. Well, I think your argument about the compliance is also a pretty one. In other words, you say that when people have refunds, they are much more anxious to file their tax returns than if they don't have a refund, or than if they owe.

Mr. BLOCH. Exactly.

Senator CHAFEE. How do you know that this occurs? Once a client is in your office and he or she gets the bad news that they owe money, do they say, "Well——

Mr. BLOCH. It is possible they will not——

Senator CHAFEE [continuing]. Forget it. I don't think I will file."

Mr. BLOCH. That is a definite possibility.

Senator CHAFEE. And you sternly warn them of the——

Mr. BLOCH. In fact, they may not even come back to the office to pick up their return.

Senator CHAFEE. I hope they paid you in advance.

Mr. BLOCH. Sometimes they do and sometimes they don't.

The other point I was going to make today which really is on the main subject which is to provide tax relief to middle income people.

I know that the Committee is looking at several bills. I think really there are three different types of relief; one is tax credits, a second is increasing the personal exemption, and the third is liberalizing IRA's.

We have looked at Senator Bentsen's S. 1921 and believe it is very well intentioned and a step in the right direction. But we think—really we recommend two things: One is that the credit be refundable so that it really helps all types of middle and lower in-

come people, and the second part of our recommendation is that it is not just limited to children.

There are a lot of taxpayers, some young who don't have children and they are in this middle income class that could probably very well use this credit. There are also older people who may not have children or whose children may have grown and are no longer dependents who could take advantage of this excellent credit.

So basically we prefer refundable tax credits and ones that are not limited just for children. And we think that it would not be unreasonable to pay for such tax relief by increasing the tax rates on the wealthy taxpayers: The same class of taxpayers who benefitted from the tax cuts in the 1980's.

In particular, proposals to impose a surtax on million dollar incomes or create a new tax rate for wealthy taxpayers merits your serious consideration.

So that basically is what I wanted to present, Mr. Chairman. I appreciate the opportunity to appear before you today, and I would be happy to answer any additional questions. Thank you.

Senator MOYNIHAN. Thank you, Mr. Bloch.

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

Senator MOYNIHAN. And we want to thank you all. I guess I want to say to you, sir, not to give you private advice but the decision to cut the withholding has been taken and it is not going to be reversed. I mean it could be, but it's not going to be. The President would have to sign the thing.

Just in order of the—I'd like to make a few comments and Senator Chafee certainly will.

Dr. Fisher, that was very positive information you had. Could you say again that description? You made the distinction between technology discoveries and the old time discovery of the spindle top or what not; that the——

I had a great moment in my life. Twenty years ago I was inducted into the American Philosophical Society which Franklin founded up in Philadelphia. I was at a dinner the night before and I was seated next to a gentleman and I asked what he did. He said that he was a geologist and I said, well, that's a wonderful calling. It must be an exciting time with plates and all that. A very mild man.

And from across the table his wife said, "tell him what you did, Henry." And I said, "Sir, what did you do?" He said, "I discovered the Arabian Oil Dome." I think of that and he probably never made $30,000 a year in his life, but he was a geologist and very happy and he discovered the Arabian Oil Dome.

But the technology discoveries that you are talking about. Now you talked about or described a—I don't want to put words on you, but you described an energy rich nation there. Is that what we heard, sir?

Dr. FISHER. Yes, that's right. The remaining resource base in this country is yet substantial. What has declined is our ability to make giant field discoveries.

Normally in the approach to a resource base, you go for the larger fields first. Those for the most part have been discovered in the United States. There are still some areas in some of the frontiers offshore and in Alaska, where that kind of economy still exists.

Senator MOYNIHAN. I believe we have drilled about half the number of oil wells in the world.

Dr. FISHER. Well, probably closer to 80 percent of those in the world, yes.

Senator MOYNIHAN. What, sir?

Dr. FISHER. Probably closer to 80 percent of those drilled in the world. It is a tremendous number.

Senator MOYNIHAN. So we've put as many holes down in—if there is something really big out there, we would have likely have found it by now.

Dr. FISHER. But in that effort, we still recover only 1 out of 3 barrels of oil that we find. So there are two-thirds of the oil remaining in place. That's where a lot of the technologies come in and the ability to improve the recovery. And while those come in relatively small increments, they depend upon technologies as a basis for the efficiency.

If you can make a discovery of a billion barrels at one time, which we can no longer do in this country, then technologies don't mean a whole lot to you. It becomes a secondary feature.

We don't have that opportunity now. We've gone from economies of scale to economies of efficiency. And if we apply those, we have a very large resource base remaining.

And that is why it is necessary not only to have efficiencies but have a substantial number of wells drilled. That is the point that Mr. Ames was making and so we've got to do the things that would encourage a greater amount of drilling.

We have to drill more, but we don't have to drill an infinite amount, but you have to drill substantially more and with greater efficiency, and that opens up a very large resource base.

Senator MOYNIHAN. Could I ask you as an economist—it's a wonderful field; Bureau of Economic Geology—would you agree with Mr. Ames that the Tax Code is a major inhibitor of new drilling at this point?

Dr. FISHER. It is in terms of the Alternative Minimum Tax. In the sense that tax caps the investments by independents. And so that is an inhibitor. That is a disincentive. That should be restored back to what we have historically—we've historically used the Tax Code to encourage the independent operator to develop the more marginal part of the resource base. That's one of the reasons we have drilled 80 percent of the wells in the world because we have encouraged that. And I think to the very good benefit of the Nation in the fact that we've had those resources available to us.

Senator MOYNIHAN. My time is up for the first round, but Mr. Ames, I make the point that you are a lot better off having Dr. Fisher making your arguments. It's a very impressive thing. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Bloch, what do you consider to be a middle income taxpayer?

Mr. BLOCH. I would say between $25,000 and $75,000 a year.

Senator CHAFEE. This is antidotal, I know, but——

Senator MOYNIHAN. The Chair has previously ruled that "data is the plural of antidote." So antidote is altogether in order in this panel.

Senator CHAFEE. Good. Well, I thrive on it.

The President has proposed a $500 additional exemption per child. And so what I did was I took—figured half the taxpayers in the so-called middle income were in the 15 percent bracket and half were in the 28 percent bracket, and so it worked—and then took that figure and divided it by the number of days in a year. But anyway I came up with $0.96 a day per child would be what the taxpayer would get out of it.

Do you have any feeling from your numerous customers—clients, as to how enthusiastic they are for that - recognizing that it would probably add about $5 billion a year to the deficit which their children would have to pay?

Mr. BLOCH. I think middle income taxpayers would welcome any type of tax relief, but I think they would prefer to see a credit over a deduction. The increased exemption for children really doesn't help those folks that don't have children. And I think an argument can be made that they deserve a break too.

I think the higher exemption for children really benefits the upper income people more than it does the middle and lower income people. So that is another reason why I think a credit would be much much better and a refundable one would be the best.

Senator CHAFEE. I suppose that you get no feel one way or the other on it and taxpayers don't come in and worry to you about the Federal deficit.

Mr. BLOCH. I think we hear comments about it, but I'm not sure I would be an expert on that subject.

Senator CHAFEE. Fine. Thank you very much.

I'm sorry I missed the testimony of the rest of the witnesses but I will review your testimonies.

Senator MOYNIHAN. Excellent testimonies. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. I would like to hear the next panel.

Senator MOYNIHAN. Well, in all truth, we have one last panel to go, and in fairness to them, I think we probably want to thank you all.

We've heard you very carefully about passive losses. We begin to learn more about the subject as we continue our tireless tinkering of the Tax Code.

Particularly, Dr. Fisher, it is an honor to have a scholar of your eminence and you come all the way from Texas, and we thank you all and good morning to you.

Dr. FISHER. Thank you.

Senator MOYNIHAN. And now we have the concluding panel of the morning. Two most distinguished economists; public servants and citizens. And I think I can say it is my particular pleasure to say friends in both instances.

I believe it's the case that Mr. Kudlow has not been able to be here. Well, Dr. Frances Bator is here. A member of the Kennedy and Johnson White House. When he departed the economists recorded the event as a great loss for the—of the republic, but even so, we have sort of survived, since he didn't leave us and simply went to teach at Harvard where he is the professor of International Political Economy.

Dr. Bator, good morning, sir. We welcome you. We have put your statement in the record as if read or do exactly as you like.

STATEMENT OF FRANCIS M. BATOR, FORD FOUNDATION PROFESSOR OF POLITICAL ECONOMY, KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. BATOR. Thank you, Mr. Chairman, Senator Chafee and Senator Bradley. I am professor of political economy at the Kennedy School. As the Chairman pointed out, I learned my politics from Lyndon Johnson.

During 1965–67 I served President Johnson as Deputy National Security Advisor with responsibility for American/European relations and for foreign economic policy.

I am honored to be here.

Getting fiscal policy right is never easy. But I believe your current task, Mr. Chairman, is unusually complicated. We are plagued by two macroeconomic ailments. They call for opposite fiscal actions. And the public believes—mistakenly—that the action that is more immediately needed is, in itself, wrongful.

The problem for the long term is to overcome twenty years of slow growth in productivity and almost no growth in real wages. A necessary remedy for that is more investment by both government and business, in people, in technology, in infrastructure and in machinery.

To free up the workers and capacity that will be needed to produce the investment—once the economy is approaching full employment—we will have to reduce the relative share of consumption—including defense—that is increase national saving.

The only reliable method for that is to make the deficit in the Federal Government's structural operating budget much smaller, indeed, to turn it into a surplus by the end of the decade.

The problem for the near term, however, is to reverse the rise since mid-1990 in unemployment. It has been caused by a shortfall in total demand relative to potential output. As a result, a large gap has opened up between what we are actually producing and what we can safely produce without speeding up inflation.

To make more certain that the gap begins to narrow this summer, we should now take budgetary action to boost demand; perforce, that will make the 1992 and early 1993 deficits—but only those deficits—substantially larger.

Figure 1, Mr. Chairman, on Page 11 of my statement shows the situation, I think, clearly. I don't know whether you have it in front of you.

Senator MOYNIHAN. We do. We do. Yes.

Dr. BATOR. The upper line is an estimate of the inflation-safe capacity of the economy to produce goods and services sometimes referred to as potential output. It is that level of output that gives rise to an unemployment rate of about 5.5 percent, which is, on current estimates, when the labor market is in reasonable balance.

Senator MOYNIHAN. That is what you used to call a full employment level.

Dr. BATOR. Full employment level. Yes.

Potential output is currently growing, as a rough estimate, at about 2.3 percent per annum.

The lower line plots the actual path of real GNP—all of this is measured in billions of 1982 dollars. You can see the almost perfect inflation-safe recovery path from the deep recession of 1982 and

then the flattening of demand and output during late 1989—early 1990, and then the dip down—I have it into the third quarter. I don't have the fourth quarter in there. It is absolutely flat from the third

The gap now measured in current-valued dollars is roughly $250 billion or about $3,300 per American family.

The short-term task I referred to is how to close that gap: How to make sure that it begins closing this summer.

The long-term problem, much the harder, is how to make that upper path steeper.

Curing the long term malady, as I say, will be hard and painful. Overcoming the immediate problem is both technically relatively easy and the opposite of painful—everyone benefits. But it is complicated by the notion that budget deficits are in and of themselves wrongful. I believe that notion is mistaken.

Deficits, even very large deficits, are not bad as such, any more than are taxes or government spending. It depends on the economic situation, and on what effect one wants the budget and money to have on the economy: on total output, employment, and inflation; on how output is divided among consumption and investment, both private and public; on the distribution of income, and on the microefficiency of the economy. Those are the things that really matter.

We sometimes talk as though what mattered was the effect of the economy on the budget. The truth is the opposite.

Don't misunderstand. I believe that the 1984–1989 deficits were very bad deficits—they did grave damage. Coming on top of the decline in private saving, excessively stimulative Federal budgets caused public and private consumption to grow much faster than the economy's inflation-safe recovery path. To make room—to prevent an inflationary boom—the Federal Reserve was forced to compress by means of very high real interest rates the two other components of spending.

Senator MOYNIHAN. Dr. Bator, please pay no attention to the timer and nor will you, Dr. Chimerine when your time comes. Pay no attention to it.

Dr. BATOR. Thank you.

As I said, the Federal Reserve was forced, because of this very stimulative budget, to compress the other two components of spending—domestic investment and net exports. As a result, the share of those net-worth increasing shares fell from over 9 percent of GNP during 1950–1979 to less than 4 percent during 1982–1989.

Actually the figures are even more dramatic than that. I fudged them here a little because the recent revisions in the National Income and Product Accounts, suggest that the pre-revised figures may have overstated it. The precise pre-revision figures that I calculated showed the share of output drawn into net domestic private investment, plus public infrastructure investment, civilian, plus net exports, averaging 9.6 percent of GNP during 1950–1979 with very little variance. The lowest single year, Mr. Chairman, was in 1975—the bottom of the recession it was 6 percent.

1982 to 1989 by the pre-revision figures averaged a little over 3 percent—maybe 3.5 percent. That outcome, I should say, was entirely predictable, Mr. Chairman; the outcome that a very expan-

sionary fiscal policy combined with a successfully anti-inflation protective monetary policy would produce that result—that is not hindsight.

Senator MOYNIHAN. Do you have this as a table somewhere?

Dr. BATOR. Yes, I do, and I will submit it to you.

Senator MOYNIHAN. By all means, please——

Dr. BATOR. At the moment, I'm afraid, all those figures are in a table in my handwriting, and I don't want to impose that on the—even on an old friend if I may say so.

But for now, with the already large gap between actual output and potential output getting larger, consumption and investment are not, as a practical matter, rival. As long as there is a large supply of unemployed workers and idle capacity, and inflation is under control, a temporary increase in the deficit and a one time jump in the Federal debt need not crowd out either domestic investment or net exports, and consequently need not impose a significant burden on the future.

On the contrary, as long as the Federal Reserve aggressively counters any upward pressure on interest rates, tax-cut induced spending on consumption that improves capacity utilization is likely to give rise to more rather than less business investment.

According to the mainline forecasts, the economy will turn up this spring or summer even if we take no fiscal action. That seems to me a good two-to-one, perhaps even three-to-one bet, assuming that the Federal Reserve drives interest rates still lower, and collaborates with the Treasury to flatten the yield curve. But that implies a one-in-four chance that the economy will remain flat, or worse, go into a far more dangerous downswing. The longer final demand remains flat, and unemployment and idle capacity keep rising, the greater the risk of a stall-out.

I do not think, Mr. Chairman, that risk is worth taking. Prudence demands that we take prompt, self-terminating fiscal action designed to produce a first-round increase in total spending on the order of $50–$60 billion annually—approximately 1 percent of GNP—during the next year.

Think of it as insurance against a one-in-four chance of continued stagnation, or a nasty second recession. The likelihood that a 1-year fiscal push of that size would produce an inflationary boom, under these circumstances, seems to me negligible.

The precise content of a stimulus package matters less than that it be prompt, large enough to matter—though not larger—and temporary.

There are many choices. Two months ago, Robert Solow and I suggested one possible program, consisting of an across the board, 1-year-only flat percentage increase in all grant-in-aid checks written by the Federal Government to the states, cities and localities, and an across the board flat percentage reduction, for 1 year only, in all Federal income and payroll tax rates.

But whatever temporary fiscal actions you choose to take, please take them quickly. I would respectfully urge that you not get bogged down in debate about income distribution, tax justice, and who is middle class; it is bound to get in the way of prompt action. After all, the measures would be for 1 year only; the simpler the better.

The object is to increase total demand, not to redistribute income or even to try to shift its composition in favor of investment. All that is enormously important, but cannot possibly be well decided quickly, especially in an election year.

I'm afraid the President's program is not that kind of program. So it's up to the Congress. You might even want to make yours a two year program, but stoppable or reducible by a single presidential decision, when he believes that the evidence of a turn around is clear and strong.

You, the Congress, choose the precise content of the package. He, the President, chooses when to stop within the 2-year limit.

You are being told, Mr. Chairman, not to take short term action that will harm us in the long term. It is a good rule. But I would couple it with another. Take whatever action will help in the short term as long as it does not hurt in the long term.

The first part says that permanent tax cuts that stimulate consumption are a very bad idea. The second part says that temporary, self-terminating action to stimulate demand in the near term is a good idea.

On the long term, Mr. Chairman, and I will make this brief, suffice it here to say that:

(1) Absent a fortuitous increase in private saving, merely balancing the government's structural operating budget by the end of the decade will not suffice to restore the national investment share to its 1950–79 level. To supplement meager private saving we are likely to need positive Federal saving.

(2) Trying to increase national saving by tax concessions designed to stimulate private saving is a losing proposition.

I can address that question, Mr. Chairman, if you like, but I'd like to skip this part just to save time.

Senator MOYNIHAN. Well, that's a pretty important part to skip. Don't skip that one. It says what we are going to do is useless.

Dr. BATOR. (2) Evidence indicates that the total amount of private saving—and I now go back under the Chairman's instruction—evidence indicates that the total amount of private saving—the amount of their after-tax incomes that private parties choose not to spend on consumption—is affected hardly at all by changes in the after-tax return to saving.

You just can't find it in the evidence——

Senator MOYNIHAN. Thank you.

Dr. BATOR. Moreover, most tax measures aimed at boosting private saving will reduce revenue and thus reduce government saving, if measured properly, along a given inflation-safe GNP path. The net result is likely to be a reduction in total national saving, which is what matters, as well as a more unequal distribution of incomes.

(3) The peace dividend will help. But even a dividend on the order of 3 percentage points of GNP—that would cut the defense share from its peak of 1989 by half—even a 3 percentage point cut in the defense share will take us only about half way to the saving we need. To achieve the rest, we will have to either cut civilian spending or increase taxes or do both.

In light of that arithmetic, I don't see how we can get away without a substantial increase in taxes. My own preference would be for

-taxing energy and pollution, and for some kind of value added or national sales tax, carefully tailored to protect the poor.

But in any case, when thinking about the tax burden, we should remember that all taxes relative to potential GNP in the United States, currently at about 32 percent, is significantly lower than in any other Western industrial country. I can submit those figures if you would like to have them. There is a dramatic difference.

Senator MOYNIHAN. Please, we would.

Dr. BATOR. Contriving a large shift from consumption to investment, private and public, is a delicate operation. Budget tightening by itself will only compress demand and free up workers and capacity. To make sure that they are drawn into producing machine tools, bridges, computers for schools, and trained teachers and exports, the Federal Reserve will have to offset budget tightening with still more aggressive monetary easing.

Public investment will have to increase substantially, and we may even need some carefully pinpointed tax devices for stimulating investment, such as an investment tax credit. Over the long pull, reducing the capital gains rate will not increase national saving and is in any case a very inefficient way to stimulate productive business investment.

When thinking about the long term problem we should keep in mind that we are a very rich country, much richer than in the past, and significantly richer still than any of our richest friends.

The notion that we cannot afford to do what we need to do, for schools or cities or the poor, or in Eastern Europe, seems to me nonsense. In 1990, GNP per family of standard size—if you divide the entire population of 252 million into family size units of 3.21 persons, which in 1989 was the actual average family size, you get currently about 78.5 million such units. Divide the GNP evenly among such representative families and what you get is $71,000 per family.

Ten years ago the corresponding figure in inflation adjusted dollars was $61,000, 20 years ago $51,000 and in 1950, $34,500—that's when we did the Marshall Plan.

The figures for after-tax, after-transfer disposable income were $52,000 in 1990, $44,000 plus in 1979, and $23,000 in 1950. Personal consumption per family in 1990 came to almost $48,000 as compared with $39,000, 20 years ago and $21,000 in 1950. That is the good news.

The bad news is that:

Since 1973 we have not been growing richer fast enough. Moreover, much of the growth we've had has been due to our working more and harder. That's why it is so very important, once we have got this recession under control, to start seriously doing something about the long-term saving and investment problem.

The other piece of bad news, Mr. Chairman, and I will now finish, has to do with the distribution of income.

The distribution of income and consumption is extraordinarily uneven, and has become distinctly worse since 1979. Were I to revise this statement, I would probably list income distribution as our third major problem. But that too is for the longer term future.

Thank you very much.

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

Senator MOYNIHAN. Thank you, sir. We will get to the questions in due term.

And now, of course, we have the great distinction—the equal distinction of hearing from Dr. Chimerine, who, in his time, has been Chief Economist at Chase. Weren't you that?

Dr. CHIMERINE. You remember. Well, thank you.

Senator MOYNIHAN. And is today the Senior Economic Counselor of Data Resources, Inc. and McGraw-Hill down, for some reason, in Wayne, PA. You don't have to explain that, but we are happy to have you. Please proceed, sir.

STATEMENT OF LARRY CHIMERINE, Ph.D., SENIOR ECONOMIC COUNSELOR, DRI/McGRAW-HILL, WAYNE, PA

Dr. CHIMERINE. Thank you, Mr. Chairman. I am delighted to be here. It is good to see you again, Senators Bradley and Chafee.

I would like to start, Mr. Chairman, with a brief review of where the economy is today and how we got here, because I think that is a necessary starting point for the development of any kind of policy package.

There is some very unique aspects of this current economic situation; highly unique, that I think require a much different approach to stimulating the economy in the short term than we've ever had before coming out of any recession. And I think it is worth a few moments to focus on what these differences are.

First, it is important, for everyone to understand that this period of economic weakness that is now still in place has been here now for almost 3 years. In fact, it is probably more than 3 years by this point.

The economy began to slow down dramatically in early 1989, and even before the official recession date, as designated by—whoever designates these things now—in July or August of 1990. We had already had 18 months of essential stagnation until that time. And of course that was followed by the recession——

Senator MOYNIHAN. 1989?

Dr. CHIMERINE. In early 1989, economic growth slowed dramatically, and from early 1989 to the summer of 1990—an 18-month period—we had average economic growth of barely more than 1 percent. After population growth, that is as close to stagnation as you can get. This preceded the official recession.

So the economy has been weak now for 3 years and, as suggested earlier today, at this point, there is no meaningful evidence that any upturn is underway.

And by the way, this recession has not been mild. There is an extraordinary amount of pain and suffering in this country, and no matter what adjective you want to use to describe it, it has been a long period of slow growth and recession, creating sizable distress throughout the United States.

It is also not an oil-shock recession. The economy was weak, as I said a moment ago, for 18 months before the invasion of Kuwait. New England and most of the Northeast, and other parts of the country, and many industries, were already sliding downward very sharply during that period; again, well before the invasion.

It is not a Federal Reserve induced recession. It was not produced or caused by the budget accord in late 1990; the economy,

as I said earlier, was already weak for an extended period before those tax increases, and before that budget agreement.

This is a fundamentally different recession or period of weakness than we have ever experienced before. And I think the differences are three-fold.

First, as I have mentioned, the downturn was preceded by 18 months of stagnation. This has never happened before. In every other recession we have experienced previously in this country, we've gone almost immediately from sharp growth, from rapid expansion, into recession: The economy would peak out and start declining within a matter of a month or two.

So obviously something must be different here if the economy was already so sluggish for 18 months before the downturn began.

Secondly, the impact on labor markets this time around has been far different. As I think everyone here knows, traditionally in recessions, most of the increase in unemployment takes place in manufacturing industries, particularly durables manufacturing—industries like autos—and most of the workers usually affected are production workers. In turn, most of those are put on layoff, for indefinite furlough. But they were getting unemployment benefits, they were getting Union benefits, and they always expected to get their jobs back. Once the economy picked back up and their industries began to improve and they would gradually be recalled. Some perhaps after a year or even longer, but they did not consider themselves unemployed.

This time around the increase in unemployment has been spread far more across industries and occupations than has ever been the case before. We are seeing it in retailing, in banking, in accounting firms, in law firms; that may be the silverlining in all this, but I'll leave—there are no attorneys here—so we will skip the attorney jobs.

Senator CHAFEE. Well, isn't that partially true and I just interrupt briefly—isn't that partially true because the percentage of the work force in these other areas is greater than it has been in the past?

Dr. CHIMERINE. It is partially for that reason, Senator Chafee, but it goes well beyond that in my judgment. It is partly a reflection of a more broader based weakness in the economy, partly the banking problems, partly the over-building of the 1980's; particularly in retailing——

Senator CHAFEE. Well, I don't want to slow you up in your——

Dr. CHIMERINE. But it is partly because services represent a larger share of the economy, but by no means is that the full explanation.

And by the way, these jobs that are being lost are not layoffs. These are terminations. These jobs are lost forever, or for many many years at least.

The people who are being affected don't think of themselves as being temporarily idle, on layoff, soon to be recalled, or to be recalled eventually. This is a very different situation, with significant implications for any potential recovery, because there is more wide spread fear of job loss in this country now, and job anxiety, than I've ever seen in my career and it has become an additional restraining factor on the economy.

A third major difference is what caused this period of slow-down/recession in the first place, and I feel quite strongly about this. This has not been produced by the traditional cyclical factors that have caused our previous recessions, like inventory overhangs or brief periods of tight money, or a temporary inflation shock.

This has been caused far more by longer lasting structural factors than any downturn we have had before in this country, and I think everybody here knows the factors that I am talking about. First, the explosion of private debt in the 1980's which has now become a constraint on new spending because people and corporations are overburdened with debt.

Second, the over-building of real estate, which has now become another constraint, because we have seen a literal collapse in new commercial construction because we are already so terribly overbuilt.

Third, the strains in the financial system. No longer are dead people and cats and dogs getting credit cards in the mail, like they did in the 1980's. Now credit cards are being withdrawn in some cases. Credit standards have been tightened across the country, which is now a limiting factor on economic growth.

Fourth, restrictive fiscal policies, and the State and local budget problems—all of these factors and several others I didn't mention, which are now limiting economic growth and preventing any meaningful recovery, are much more long lasting than the typical cyclical factors that have produced previous recessions.

They will take years to overcome, and that is why we've already had such a long period of weakness, and that's why the people who expected the economy to rebound after the war ended were wrong, because this was not an oil shock recession. It is caused principally by these longer lasting structural factors that I have just mentioned.

I think that this may be a slight exaggeration, Mr. Chairman, but when we look back at the 1980's, and I know you and I have had this conversation before, we had an artificial expansion. It was an expansion built on big military and construction booms, on a consumer spending spree, financed partly by tax cuts we couldn't afford, on a massive upward leveraging of the economy, and by borrowing heavily from overseas. You can't generate long-term expansions on these factors.

Quite the opposite, these are being reversed and we've got nothing left to take their place because the underlying fundamentals are so poor.

We didn't improve our savings in the 1980's; we reduced it. We didn't increase our investment; we cut it. We didn't improve our competitiveness; it's probably at the worst it has ever been in the history of this country. We haven't improved the quality of education, and so on down the line.

And now that these temporary sources of economic expansion have slowed down or are being reversed, we have nothing to take their place, and that's why we are in the midst of this long process of stagnation or slow-growth or adjustment—whatever you want to call it. I think that's the right way to look at this period.

This recession is thus not a separate or isolated event. It is part of a period of slow-down and adjustment that began 3 years ago,

and very likely will go on for much longer unless we change economic policy in this country.

We simply did not build for the future in the 1980's. We mortgaged our future. We had no supply side miracle. If anything, we've done long-term damage to the country. That's where we are today and that's a realistic way to look at the current economic situation.

Now there are a few bright spots. People are now taking advantage of lower——

Senator MOYNIHAN. Now we are going to get to the bright spot?

Dr. CHIMERINE. Yes.

Senator CHAFEE. How are we going to relieve the gloom around here?

Dr. CHIMERINE. Well, I will get to that in a moment.

We could see a small pick-up later this year. As Francis mentioned a few moments ago, people are taking advantage of lower interest rates—by refinancing existing debt which will lower monthly payments and free up some purchasing power.

We are also seeing some pick-up in housing now in response to lower mortgage rates. Oil prices are down. So there are a few favorable factors. But there are still these long-term factors that are restraining the economy.

De-leveraging is a particular example: The U.S. economy is now in the midst of being de-leveraged. We are reversing the debt we created in this country in the 1980's, and that will continue to be a constraining factor.

It has already been limiting the impact of the Federal Reserve on the economy and will continue to do so. No one wants to go out and borrow more. The effect of lower interest rates, at best, will be through refinancing and freeing up some purchasing power, not through getting people to go out and borrow a lot more to finance new spending.

The confidence problem we talked about: People are so scared that even if they do get some more income, it's not clear that they are going to spend it. We've got massive deflation in much of the economy, and it's caused an enormous revenue squeeze for corporations, which is forcing them to do all this cost cutting.

Some of this will make these companies more efficient in the long-term, but in the short-term when everybody cuts their costs by laying off more workers, there is nobody to buy their product.

So these factors are limiting the economy so in my own judgment, there is absolutely no reason to believe, and no evidence to support the view that we are about to launch on a strong sustained economic recovery much like those which followed every previous recession we have had before.

If we are lucky, we will get a modest pick up. It's questionable whether even that can be sustained and there remain sizable downward risks and sizable constraints on economic growth. And as I result, I do believe we need a stimulative package.

I don't think we can rely only on the Fed for the reasons I have mentioned—because of excessive debt, and because we are terribly overbuilt—builders are not running out and building new empty office buildings because mortgage rates are down 50 bases points—and because the banks are reluctant to lend because they are in the process of down sizing.

All of this reduces the effectiveness of the Fed, and therefore, I think we do have to do something on the fiscal side.

And I couldn't agree more with the observations that have been made this morning. We must find a way to deal both with the short and long term at the same time. I don't think it is impossible. I am going to give you my prescription in one moment.

But the key here is to find some way, in the short-term, to stimulate the economy and improve the job market while simultaneously addressing our key long-term needs, and those are the ones that Francis mentioned a few moments ago: Productivity and competitiveness.

We have had anemic productivity growth in this country. It did not improve in the 1980's despite the supply side predictions.

As a result, real wages are flat—and that is even a bigger constraint on spending than confidence—since you can't spend confidence.

People are not spending primarily because of the income squeeze. They are losing jobs. Real wages aren't rising. And tax burdens are going up. And of course they have massive debts to service.

That's the biggest constraint on spending and the fact that people feel very badly and have great anxieties only compounds the problem, but is not the fundamental source.

Not only that, the weakness in productivity, in my judgment, coupled with other factors, has caused a dramatic decline in U.S. competitiveness in world markets.

We no longer have the advantages in productivity, in product quality and in innovation and technology that we did for 20 or 30 years, during which we dominated the world economy.

In most key industries, the rest of the world is catching up, or already has caught up, in productivity. Even in new technology and the adoption of new technologies, we are no longer as dominate as we were. And of course nobody thinks we produce the best products many more in many industries. We do in some.

When we had those advantages—when we were much more productive than everybody else, and our productivity was growing, we used those advantages to improve living standards in this country.

We raised wages on a regular basis. We created millions of high paying corporate jobs. That is now being reversed primarily because this country is not improving its productivity and because as a result our productivity advantages are being eroded, are in some cases, have already been lost. That should be the focus.

In my judgment, Mr. Chairman, I think we need a national economic strategy. A multi-dimensional strategy that addresses how we are going to get more investment, more productive investment. What are we going to do to improve the quality of education? How are we going to rebuild the infrastructure? And deal with health care costs, and a whole range of other issues, which I don't have time to discuss this morning.

But it seems to me the focus has to be to increase investment in order to improve productivity and competitiveness, and investment has three dimensions.

First, private investment in productive type activities—not mergers and acquisitions and LBO's. But new equipment to modernize our plants. New capacity. New industries and so forth.

Secondly, human capital. We have neglected education in this country and job training, and we are far behind most of our major foreign competitors, and the gap is widening.

And thirdly, public investment—infrastructure which is a main supporter of the effective operation of the private system, and without it, we can't have maximum productivity in the private sector.

And our objective should be to increase those three in order to improve long-term prospects. But to do so in the short-term as well.

We thus need an investment-led recovery. Not a consumer led recovery. And to accomplish that, we need policies that are very creative; that get maximum bang for the buck because we absolutely must find a way to stimulate the economy, not only in a way that addresses our long-term needs, but does so in a way that does not increase the deficit.

We are doing enormous harm to this country. These deficits are sucking the vitality out of this economy, creating unconsciousable burdens on the next generation, and we ought to be cutting them in the long term. And anything we do to stimulate the economy as a result, shouldn't raise the long-term deficit or else it will be counter productive.

Now with that background, let me take a minute to review the Administration's proposal.

Senator CHAFEE. Well, you want the deficits reduced. You want to do something about the infrastructure of the Nation. You want to improve the education in the Nation. How are you going to pay for all of this?

Dr. CHIMERINE. I'm going to tell you. Can I have one moment?

Senator BRADLEY. Why don't you just get to your program.

Dr. CHIMERINE. Okay.

Let me start by briefly focusing on the administration and where I think it is wrong and then get to my program.

A lot of the points have been made already today, but my two big disagreements are—number one with the capital gains tax cut. The evidence is clear that cuts in capital gains do not significantly increase fixed investment and economic growth in the United States.

Senator MOYNIHAN. I don't mean to interrupt, but you and Dr. Bator have just said the same thing. Is that right?

Dr. CHIMERINE. Well, I believe so.

Dr. BATOR. There are two problems involved in increasing the share of investment in GNP, once you get to full employment and no longer have idle labor and idle capacity. In order to make room for extra investment, you have to increase saving; either private or by government.

Senator MOYNIHAN. But apply to the capital gains.

Dr. BATOR. A capital gains tax cut may serve as a stimulant to investment by reducing the cost of capital; my guess is that it is negligible. But what it will certainly not do is increase saving and release the resources that would be needed for that investment once we are at full employment.

Dr. CHIMERINE. It does not, Mr. Chairman, significantly reduce the cost of capital. A much more effective way to stimulate investment in my judgment is with the investment tax credit. It has worked in the past. It does reduce the cost of capital.

I think the Administration's proposal is anemic. All it does is affect the timing of depreciation. It has no impact on the price of an asset, and would affect the cost of capital marginally, almost negligibly.

Senator BRADLEY. Well, it is about the equivalent of a 1-percent investment tax credit.

Dr. CHIMERINE. Just about.

My proposal has been and remains, Mr. Chairman, enactment of a large investment tax credit; something like 20 or 25 percent, but on incremental investment only. What we need to do is provide an incentive at the margin without giving away revenues for investment that would happen anyway. We can't afford to do that. And a 20 or 25 percent investment tax credit would be very stimulative at the margin in my judgment.

It should be limited to productive investment. I hate to use this phrase "self-financing" after what we have been through in the 1980's, but it would probably come closer than any other tax cut because it costs nothing if it doesn't work.

If it doesn't produce any incremental investment it doesn't cost anything. If it does, then you do have a credit, but by definition, you have more investment and more economic activity.

Secondly, the acceptance of $200 billion deficits as in their budget, even with the mythical savings, optimistic assumptions and accounting gimmicks, as I said earlier, is just unconscionable.

We are really building in $300 billion a year deficits for the next 5 years, and even bigger ones later in the decade when the defense savings bottom out and when we starting drawing down the trust funds. This is just unconscionable and unacceptable.

My proposal is a large incremental investment tax credit. If you want to do anything on capital gains, I would give you two choices:

(1) Change the structure of capital gains by raising the capital gains tax rate on short-term investments—a sliding scale kind of thing—because all you can do really with capital gains is shift the focus away from the short-term financial investment more toward longer term investment. But you need a big differential to do that. Going from 25 to 15 or 28 to 15 is not going to encourage long-term investment.

(2) As an alternative, I would consider the Bumpers proposal which is to limit a capital gains cut to new enterprise. We don't need to stimulate the stock market. It is already setting records.

What we need is fixed investment and new business formation and a straight reduction in the capital gains tax is just not the way to achieve them and it would likely be a big revenue loser. We can't take the risk of implementing anything that will lose more revenues. We already have a gigantic deficit.

One last comment, and that's on IRA's, I agree strongly with the comments made earlier. You ought to reject two things as part of any stimulative package, Mr. Chairman.

First, we don't need a middle class tax cut. It will be too small. It will become permanent. It will widen the deficit. It does nothing for competitiveness and productivity in the long-term, and it just won't be helpful—particularly in this environment where, at best, it's likely to be saved because people are concerned about their jobs, and they're trying to reduce debt.

Secondly, we should not fiddle with IRA's. Most low income people don't have IRA's. They can't draw them down to finance a new house.

There is a perception in this country that people sit around their dining room table every week and make a decision on how much to save by saying "well, let's look at the Tax Code and we'll see how much we will save next week."

Savings incentives have little impact on savings. People don't save more because they're being squeezed. What you are likely to do is simply widen the deficit without either stimulating spending or savings.

I'd be happy to respond to other issues, Mr. Chairman, but I think I will stop here.

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

Senator MOYNIHAN. That is extraordinary testimony and I want to see—we all have time—it's twenty minutes to one and I think we can stay here until 1:00.

I'm going to defer to my colleague, but just if I can, just to make one point on the question of fiscal drag. We haven't heard that word around here since Walter Heller left town, but yesterday we had Mr. Brady, Dr. Boskin and Mr. Darman up, and the Secretary of the Treasury was going on about jobs.

And I said that in the State of the Union message, the President had spoken at some length about the Surface Transportation Act that he had signed in December, which was the largest Public Works Program in history. And which specifically addressed the issues of productivity and cost accountability and pricing.

We wrote a Transportation Program based on productivity and pricing. Boskin told us informally, by mail, we had asked him—what has been the productivity growth in the transportation sector? Over the last 15 years he said that the council estimated it at 0.0.2 percent. Now that's a medieval rate. It takes 350 years to double. We have tried to change all that. And I said, the President on Tuesday night in his State of the Union Address had praised the Surface Transportation Act and on Wednesday morning he cut $4 billion out of the monies we had appropriated through the Trust Fund. And I said, "Well, weren't they"—the President said jobs—wasn't that $4 billion worth of jobs, and Mr. Darman said, "Well, I had to do it because of the Andrews AFB Agreement."

The other thing is that I asked him about something which I think both of you followed with some alarm. If we don't get back to a pretty serious growth path soon are we going to get into a point where the debt, as a percentage of GNP, is growing? And he said, "yes."

And he had shown a chart that indicated the deficit would begin to grow as a share of GNP, under reasonable assumptions, and I said "would that mean in that case the deficit would be out of control?" and he said "yes."

Senator BRADLEY. And he proposes to do nothing about it.

Senator MOYNIHAN. Well, we leave that to others. In difference to our arrangements here, Senator Chafee.

Senator CHAFEE. Well, thank you, Mr. Chairman. While this has been a very interesting testimony and some of it I found heavy going, I've got to ponder over it.

Professor Bator, do I take on the top of Page 8 of your testimony, what you are saying is what—that you think that IRA's are nonsense. Is that what it gets down to? Is that what this particular language says?

"Evidence indicates that the total amount of private saving—the amount of their after tax incomes that private chose not to spend on consumption is hardly affected at all by changes in the after tax return to savings."

Is this your IRA Section?

Dr. BATOR. It is not only the IRA, Senator Chafee, it's by whatever means you increase the marginal return on saving. There are lots of different ways of doing that.

It seems not to have much of an effect on how disposable income is divided between saving and consumption. And there is a perfectly reasonable explanation for that.

If the return on saving goes up, by whatever means, one effect is that it makes future consumption cheaper relative to current consumption—you would want to save more, that in reduce current consumption in favor of future consumption.

But the other thing that happens when the rate of return, say the after-tax interest you can earn on your saving, goes up, is that the lifetime amount you have to save in order to achieve a given retirement level of wealth is less. And the empirical evidence suggests that the two effects just cancel out.

Senator CHAFEE. Okay. Now——

Dr. BATOR. This is an empirical proposition not a theological proposition. You just can't get it out of the evidence. So, making IRA's more attractive will not increase total national saving.

Senator CHAFEE. My time is fleeing by so I want to turn to Dr. Chimerine. At the end there you summarized pretty strongly. You laid it right out.

Don't fiddle with IRA's. The middle class doesn't need a tax cut. And then you espoused the Bumpers Plan which was, as best I understand it and I'm not familiar with the detail, but as I understand it, the Bumpers Plan would say that if you invest in a venture capital outfit that your growth will be treated as capital gains and you must hold it over X-years.

Dr. CHIMERINE. Basically that is right.

Senator CHAFEE. With a declining number of—with a declining percentage of the tax the longer you held it. What do we do about unlocking capital which is something that Secretary Brady stressed when he was here yesterday? Specifically take the problem; somebody has made a lot of money on MERCK stock, and they put in $20,000 and now they've got $200,000. They don't—and along comes a nice Biotech stock that somebody venture capital opportunity.

It seems to me that under the Bumpers Proposal the person holding that MERCK stock has no incentive to sell it and take the capital gain; he's locked in so that the Bumpers Proposal doesn't help him at all. Am I right or wrong?

Dr. CHIMERINE. I don't agree, Senator. It seems to me that if we don't allow a lower capital gains tax rate on old investments and we do allow a lower capital gains tax rate on new investments, we are providing a major incentive to unlock the old investments.

Under this approach, you can't get the new lower rate unless you make new investments. I think that one of the flaws in the Administration's proposal is giving the lower capital gains tax rate on old investments; then there is no incentive to unlock.

Senator CHAFEE. Well, I don't want to beat this to death, but it seems to me that the person is locked into this stock. If he sells his MERCK, all his gain is going to be taxed at ordinary income rates. So he doesn't—well, be taxed at 28 percent.

So it seems to me he knows he is going to be hit by that. He doesn't know that if he invests in this other Biotech that he's going to make some money, so the safe thing is to stay where he is. That would seem to me to be one of the conclusions.

Whereas if he has the opportunity to take advantage of the President's proposal, the lower capital gains, he would take it. Am I missing something?

Dr. CHIMERINE. No. But what I am saying is this, Senator. Suppose he would pay 28 percent on the gains he now has in MERCK stock—using your example—suppose we have a new Capital Gains Tax only on new investment, whether it's new start-ups or even new stock purchases, and suppose it's only for long-term investments: And suppose it's down to near zero for a long-term holding, what you are telling him is that if he continues to hold MERCK, and it continues to appreciate, he's going to continue to pay 28 percent tax on those new gains when he sells that.

And instead if he makes an investment in this new entrepreneurial situation and that turns out to be successful, he will pay no tax on that.

Senator CHAFEE. Well, if the tax is zero that's extremely tempting.

Dr. CHIMERINE. There is some logic to raising the rate on short-term gains and sliding it down to a very low number, near zero, for long-term gains.

If that is the objective—if the objective is to promote new long-term investment, there is a lot of logic in doing that and that would provide the incentive for unlocking existing assets.

Senator CHAFEE. Thank you.

Senator MOYNIHAN. We will have to leave that there and Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. I was taken with what you said, Larry, when you said that given what has happened in the 1980's, and you enumerated a lot of the artificiality of the economy during those years, from military to construction, to leveraging, etc., that it would take years to overcome.

And my question to you is if you know it is going to take years to overcome, the excesses of the 1980's, what would you design as your goal?

In other words, instead of dealing with capital gains on the margin verses ITC's or whatever, if you were thinking big—what would be your goal 10 years out? Then work back from the goal to the policies that you have to put in place to realize that goal. Maybe

it's X-million jobs earning a certain amount per person. I would like both of you to take a crack at that.

Dr. CHIMERINE. Well, I'm glad you mentioned——

Senator BRADLEY. And work back from the goal as opposed to trying to struggle in the quicksand right now and grab this rope or that rope.

Dr. CHIMERINE. I'm glad you mentioned that, Senator Bradley, because I did discuss that briefly in my written testimony, and I think that that's the starting point.

To me the goal should be to increase productivity within 10 years to certainly something in the range of 2 percent a year, if not getting back to the 2.5 to 3 percent that characterized most of the post war period.

Secondly, I think we need to set goals for those activities that are necessary and vital to achieve the productivity goal. For example, I'd like to set a national goal to increase our investment as a share of GNP up to what it is in our major foreign competitors, which would mean nearly doubling it or certainly raising it by 50 percent or more.

I'd like to set a goal for R&D spending as a share of GNP because I think that's important in getting more productivity.

I'd like to set a national goal for average SAT scores and so forth, and then design policies to achieve those goals.

So really the process should start with what kind of productivity growth and economic growth do we want to have? What is necessary to achieve that? What are the appropriate policies in order to produce those results? That should be the process.

Senator BRADLEY. Dr. Bator?

Dr. BATOR. Yes. Senator Bradley, if you would look at page 11 for the moment. I think it will shorten my answer.

Senator BRADLEY. Right. The graph.

Dr. BATOR. Take a look at that. By the way, you see there immediately Larry's point that the slow-down started early 1989.

Senator MOYNIHAN. Oh, yes. It is right there.

Dr. BATOR. A 4-percent rate of expansion to a 1.2 percent per annum rate of expansion long before the recession actually began.

Of course, the economy was running a little bit too hot, I would guess, for a few months. The unemployment rate actually dipped to 5.1 percent, and if you look at the series on wage rates, you begin to see some upward pressure on wage rates.

But back to Senator Bradley's question. We really have two problems. One, very short term, but that doesn't make it unimportant to get total demand, total public plus private spending to turn up this summer, and begin to narrow that gap between actual output and potential output. The longer we continue flat the greater the chance of another drop. And in that context, the debt problem, household balance sheets, bank balance sheets, the real estate market, whatever, could make that second drop much more dangerous than the first.

So I think focusing in the near term on getting a recovery started is very important even though it doesn't address the serious long-term problem.

And by the way, for the short term, I think it is entirely appropriate to make the deficit for 1992 and early 1993 still larger. That

increase in the deficit need not give rise to high interest rates and need not crowd out investment or net exports. To the extent that you don't get that crowding out, an increase in the deficit is not importantly harmful.

For the long term, I did a calculation, Senator Bradley, of what it would take to restore by the late 1990's the share of national investment—domestic investment plus net exports—to where it was on average between 1950 and 1979. It will require reducing the share of defense plus personal consumption by roughly 6 points.

Senator BRADLEY. Six points of——

Dr. BATOR. In GNP. If you want to make it possible for net exports and domestic investments to go back from 3 percent of potential GNP to 9 percent, you have to compress the other two shares by six points.

Defense will give us, optimistically, three points by 1998; we'd be very foolish if we didn't do that. That gives you three of the six points roughly.

Where do you get the other three from? You're not going to take it out of state and local government consumption; our public services are in terrible shape in any event.

All of Federal civilian consumption purchases amount to only about one plus percent of the GNP. So what you are left with is personal consumption. The personal consumption share increased between 1950–1979 and 1982–1989 from about 63 percent to about 66.3 percent. The trick is to gradually reduce the consumption share over a 5, 6, 7 year period back to where it was on average during the 1950's, 1960's and 1970's.

There is only one way to do that: to gradually reduce the share of personal disposable after-tax after-transfer income. And there are only two ways of doing that: cut transfer payments and entitlements or raise taxes.

My own view is that there are some things we need to do about entitlements, but not all that very much, and that the right way to do it is gradually to increase the tax load from 32 percent of GNP to maybe 36 percent. The Germans are at 44 percent. Britain, after Mrs. Thatcher is at 39 percent. France is in the midforties. Italy is in the low forties.

Senator CHAFEE. So the time is up can I ask a question? I'm not trying to interfere here.

Senator BRADLEY. No. So basically what——

Dr. BATOR. Have I been responsive to your question?

Senator BRADLEY. Yes, you have. So what percent value added tax would achieve this decrease in consumption? Because the more people I talk to, the more I realize that there is a question as to what is the relationship between the increased tax on consumption and the amount of reduced consumption that you would actually achieve.

Dr. BATOR. The evidence shows, and it's a fairly persistent empirical regularity, that a permanent increase in taxes of $1 gives rise to about a 70–80 cent reduction in personal consumption purchases. It is not like the gravitational constant, but it is a pretty good bet.

Dr. CHIMERINE. Can I make one comment on that answer, Senator Bradley?

Senator MOYNIHAN. Please go ahead.

Dr. CHIMERINE. May I comment quickly? Two points.

Number 1, I would strongly urge far more focus on the entitlement programs and I think that if we are realistic, and if we are going to make any cuts in future deficits, we're going to have to cut the entitlements, particularly the health and pension programs, and do it in some way that does it fairly.

We should reduce benefits significantly for people who don't need them. But there is no way you can get these deficits to acceptable levels in a 5 or 10 year horizon, in my judgment, without addressing the entitlements.

Second, on taxes, I don't think it matters that much whether you do it with a value added tax or with changing the structure of income taxes. My own preference is on the income tax side, principally because I think fairness is an issue. The evidence shows, that if you look back at the 1980's, taxes have been cut dramatically for people in the upper income groups, and they have not been reduced elsewhere, mostly because of the big increase in Social Security Taxes.

In the future, and if you are going to raise taxes, you ought to do it in a way that starts to restore more progresscifity to the tax structure and that is not easy to do with value added tax. It's possible but it's not easy.

Senator BRADLEY. So you would suggest that we put rates up?

Dr. CHIMERINE. Eventually we're going to have to raise taxes and I would do it by raising personal taxes, yes. Not now, but eventually.

Senator MOYNIHAN. In the interest of the time, it is Senator Chafee's turn.

Senator CHAFEE. And I will be brief.

Senator MOYNIHAN. Don't be brief.

Senator CHAFEE. Dr. Chimerine and Professor Bator, I just want to ask you if you were sitting here what would you do? And briefly. Now as I understand what Dr. Chimerine says, make the ITC at 20 to 25 percent incremental.

Dr. CHIMERINE. Right.

Senator CHAFEE. I don't know what you would use for your base, but let's not worry about that.

Dr. CHIMERINE. Okay. You can take that if you want.

Senator CHAFEE. Okay.

Dr. CHIMERINE. You could use 90 percent of the average of the last 3 years.

Senator CHAFEE. Okay. What do you mean 90 percent? You'd use the last 3 years as a base?

Dr. CHIMERINE. Yes. Because we are seeing some recession related slippage, so to provide an incentive, you should start from the lower base.

Senator CHAFEE. Okay. Take the base and then 90 percent of it.

Dr. CHIMERINE. Right.

Senator CHAFEE. I see. Okay. Capital gains you would adopt the Bumpers approach.

Dr. CHIMERINE. Either that or a sliding scale capital gains, more broadly.

Senator CHAFEE. Well, but the President has a sliding scale. If you mean——

Dr. CHIMERINE. I would substantially raise the top rate and I would not make the lower long term rate available on old investments. Those would be the two big differences.

Senator CHAFEE. Okay. And you might even go to zero on the——

Dr. CHIMERINE. What did I say? New? I meant on old investments.

Senator CHAFEE. Yes. You said old.

So—and you would even go to zero on new investments?

Dr. CHIMERINE. For a 6- or 7-year holding period absolutely.

Senator CHAFEE. Okay. No IRA changes.

Dr. CHIMERINE. No.

Senator CHAFEE. No middle class tax cuts?

Dr. CHIMERINE. No.

Senator CHAFEE. You're not running for re-election if you're in this post, and you'd cut the entitlements and means test them?

Dr. CHIMERINE. I don't know if that's—I don't think you'd want to do that right now.

Senator CHAFEE. Well, the medicare is certainly a serious question and why some taxpayer that is working is heart out at $20,000 a year should be paying 75 percent of Jack Kent Cooke's doctors bills.

Dr. CHIMERINE. If you're asking would I favor starting the process of putting an income cap, or an income requirement, on some of the entitlement programs, absolutely. The sooner the better.

Senator CHAFEE. All right. Now have I left anything out?

Dr. CHIMERINE. I think I'm probably more inclined to do more on infrastructure by using some of the defense cuts to fund more infrastructure type spending, but other than that I think you've got most of it.

Senator CHAFEE. All right. Just to cheer you up, I will tell you that the majority—democratic majority on Labor and Human Resources Committee has reported out that repeal grants be an entitlement.

Dr. CHIMERINE. Is that right?

Senator CHAFEE. That's right. Furthermore, there is legislation in to make the WIC program an entitlement and legislation in to make head star program an entitlement. So as we mentioned yesterday, you can just put the Federal budget on automatic pilot and we can all leave town.

Dr. Bator, as I get you, you're saying no fear of increased deficit, at least temporarily?

Dr. BATOR. 1992. Early 1993.

Senator CHAFEE. All right. And you would increase the tax load. You think Americans aren't paying enough in taxes?

Dr. BATOR. I beg your pardon?

Senator CHAFEE. Increase the tax load. You would increase taxes?

Dr. BATOR. I sharply distinguish, Senator Chafee, between the short term and the long term. We have two problems. One is——

Senator CHAFEE. You've got to be brief now. What is the short term? How long?

Dr. BATOR. The short term is—I would allow an increase in the deficit in calendar 1992 and the first half of 1993.

Senator CHAFEE. Okay.

Dr. BATOR. And I'd make that program stoppable by the President of the United States by unilateral action. A simple package.

Senator CHAFEE. Okay. And how about increasing taxes? You are really in favor of that because Americans don't pay enough taxes.

Dr. BATOR. Because we need to make room for more investment. At full employment, that means holding down consumption. Gradually between the middle of 1993 when the recovery has really taken hold until late 1990's, I would shift the Federal operating budget, excluding Federal investment from a deficit that will be still bigger next year into a surplus.

Senator CHAFEE. Now you do that by increasing taxes.

Dr. BATOR. By some combination. Defense cuts will give you 3 points on the 6 points——

Senator CHAFEE. Okay. But you would increase taxes?

Dr. BATOR. Yes. I would in the end substantially raise taxes. Yes.

Senator CHAFEE. Okay. Income taxes?

Dr. BATOR. My preference would be income taxes, Senator Chafee.

Senator CHAFEE. Personal?

Dr. BATOR. My political calculation is that it won't wash and that's why I would go second best to a national sales tax.

Senator CHAFEE. Thank you. Thank you, Mr. Chairman.

Senator MOYNIHAN. Senator Bradley?

Senator BRADLEY. Why would you prefer income taxes to sales taxes?

Dr. BATOR. I think it is easier to make it progressive, Senator Bradley.

Senator BRADLEY. Okay. Let's assume that the objective is to get growth started again. The components of economic growth have traditionally been labor, capital, and technology. New work says it's not just technology, but it's ideas and quality education; thereby implying a premium on facilitating access to better education for more Americans.

So both of you mentioned as part of your long-term objective improving productivity by promoting the growth of human capital.

So would it make sense for us to develop a pool of capital that would be available for any American up to the age of 50 to go to college? Would that help facilitate increased productivity?

Dr. CHIMERINE. Well, yes it would, Senator Bradley. In general, I am in favor of that but when you say "any American," I mean there is an affordability question. But put it this way, at least in my own judgment, any efforts to improve the quality of education in the future has to deal with two issues:

Number 1, and even more important than your point, I think, is what are we going to do to improve the quality of elementary and secondary education, and,

Number 2, ultimately to make it easier, financially more viable, for the bulk of the population to go beyond that and get college and even advanced degrees.

I don't know the best way to do it from a financing standpoint or from a structural standpoint, but I think those are the two key issues that have to be addressed and I think they are vital issues.

Senator BRADLEY. And they have to be available to more than simply 18- or 19-year-olds.

Dr. CHIMERINE. I would agree with that.

Dr. BATOR. Absolutely, Senator Bradley. I'm not an expert on adult education, although I do quite a lot of it, but it strikes me as an extremely good idea.

Senator BRADLEY. As an essential part of increasing productivity?

Dr. BATOR. I hate to single out any one thing. We need more business plant and equipment.

Senator BRADLEY. Yes.

Dr. BATOR. We need a better trained, better educated work force, and that starts, I think, in the cradle and it goes to primary education, secondary education and adult education.

Senator BRADLEY. But right now we don't have anything for anybody.

Dr. BATOR. Nothing like that.

Senator BRADLEY. Middle age or in the 30's who really want to go to college. Absolutely.

Senator BRADLEY. Now I noticed that neither one of you were very strongly supportive of the Passive Loss Restoration. I gathered that each of you thought that maybe too much of America's resources is flowing into real estate and not enough into plant and equipment. Was I wrong to detect that attitude?

Dr. BATOR. As far as I'm concerned, Senator, that's absolutely right.

Dr. CHIMERINE. I agree with that, Senator, also, but I would make one comment.

One of the unfortunate side effects of the commercial real estate, banking debacle is that it is contributing to this credit crunch. And what we need to do in my judgment in the short term is find a way to stop the drop in real estate values from reducing the ability of the banking system to make loans to other borrowers.

And there is almost a freeze on commercial real estate lending, and we may have to take some steps to either stretch out the period over which banks can reserve against some of their bad loans, or let them take the losses over a longer period of time, so they don't use up all their capital in the short term, and reduce the availability of credit to the rest of the economy.

Senator BRADLEY. I hear you directly but what you're saying though is something quite different from passive loss restoration.

Dr. CHIMERINE. Absolutely. I agree.

Senator BRADLEY. What you are saying is let's look at the financial institutions and have them accommodate the circumstance as they accommodated the farmers or the oil people or third world debt people in the 1980's.

Let's not pour more money into the real estate sector that now has 20 to 30 percent vacancies.

Dr. CHIMERINE. I agree with you.

Senator MOYNIHAN. Well, all things must come to an end. C-SPAN has been so generous with its crews and cameras and we want to thank them.

Before you leave I'm going to ask—just to get one point on wages. It seems to me in the Economic Report which you all read, there is one really dramatic number on Table B–28. It is the median income in 1990 dollars of year-round full time workers, in this case, white males, which was your basic work force. Since 1973 their income has dropped $4,500; that's 50 bucks a week.

I don't know any number that gets more to the point of what's happening to this country. In the American experience there is not the equivalent.

Dr. CHIMERINE. I'm sorry, Mr. Chairman, but there are two points I can make. Number one, for the last 15 or 18 years, real incomes have been stagnate, or very marginally better, and secondly, particularly in the 1980's, whatever slight improvement there may have been, really went to people in the upper levels. For the bulk of the population—the 60 or 70 percentile on down, there has been no growth in purchasing power or living standards for the last 10 years.

Senator MOYNIHAN. We don't——

Dr. CHIMERINE. That's the issue.

Senator MOYNIHAN. The great depression lasted 9 years.

Dr. BATOR. If you take—if we have another second, if you take the income distribution figures for the United States; they are not very good, by the way. But I think the conclusion is robust. If you take 79 to 89, therefore exclude the effect of the recession—full employment to full employment—the top quintile does very well.

The second, third and fourth, less and less well. The bottom has actually dropped absolutely has during those 10 years.

Now there is a Table in the Boskin Report that suggests, no, the bottom fifth has improved—I don't know what they have done to get that result, but I'd be very suspicious.

Senator MOYNIHAN. Every 4 years the Economic Report of the President is not under oath.

Dr. CHIMERINE. Mr. Chairman, can I make one last comment? I earlier said that I was against a middle class tax cut and I think my colleague Francis here did as well.

One thing I wouldn't be against, quite frankly, is a revenue neutral middle class tax cut, reflecting some redistribution. I think it's about time we gave some thought to a subject you're interested in, of changing the way we raise Social Security Tax revenues; namely, do we want to raise the tax ceiling and lower the tax rate in a revenue neutral way to make it more progressive and, as a result, ease the tax burden on many people.

Senator MOYNIHAN. Now that's a note that I would like to close on.

Dr. CHIMERINE. Thank you.

Senator MOYNIHAN. Before you leave, could you give us offhand, or would you like to suggest—this has been powerful testimony—would—which is the person, you, Dr. Chimerine, or you, Dr. Bator, most respect who disagrees with you?

Dr. BATOR. Most respects?

Senator MOYNIHAN. Yes. The person who you most respect who disagrees with you?

Dr. CHIMERINE. That's a tough one, Mr. Chairman.

Dr. BATOR. On the basic diagnosis or on the prescription?

Senator MOYNIHAN. Why don't you think about it, because we'd like to hear from them too, because we respect you so greatly, and——

Dr. CHIMERINE. Senator Chafee.

Senator MOYNIHAN. Senator Chafee. All right. Well, we will leave it like that for the moment. Thank you all. Thank you very much.

[Whereupon, the hearing was concluded at 1:18 p.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF EUGENE L. AMES, JR.

Mr. Chairman and members of the Committee, I am Eugene Ames, Jr., Chairman of the Independent Petroleum Association of America representing domestic independent crude oil and natural gas producers. I am also representing 45 state and regional producer associations and national, professional and service industry associations. Together IPAA and these Cooperating Associations represent virtually all of this country's independent producers, who produce 60% of the natural gas and 40% of the oil in the lower 48 states.

Thank you for this opportunity to address ways of reviving a vital U.S. oil and natural gas industry, especially at a time when solutions to our problems go hand in hand with the revitalization of our nation's economy.

The top tax priority of independent producers is the elimination of intangible drilling costs and percentage depletion as preference items under the alternative minimum tax. These AMT tax penalties on drilling are devastating the independent oil and natural gas producers, capping domestic drilling, depressing jobs creation in oil and gas producing states, which together have resulted in significant decreases in domestic oil production and increases in oil imports and the balance of payments deficit of this country.

America's independent producers, who are particularly hard hit by the AMT drilling penalties, are diverse, ranging in size from large corporations to one-person firms. But most independents are small business operators; almost 70 percent of them have fewer than twenty employees. In many respects, my own business is typical of today's independent oil and gas company. I am a third generation oil and gas producer. My business is owned by my family, and my sons and son-in-law are in business with me. I am concerned about the future of that business and the legacy I have worked long and hard to leave to my family.

The collective strength of America's eight thousand, fiercely competitive oil and gas entrepreneurs, working in 33 states, can go to work rebuilding an important part of the national economy and providing jobs to America citizens right here at home, if we are unshackled by the federal tax barriers that have forced us into liquidation.

The future should be bright for independent producers. There are substantial oil and natural gas resources yet to be discovered and produced in the United States, and those resources will be found in smaller fields that are tailor-made for independent producers. By some calculations, there is as much as 60 billion barrels of oil and 74 billion barrels of oil equivalent of natural gas yet to be discovered using new, emerging technology. Exploration for and development of these petroleum resources is absolutely necessary for America's energy security, but it will take capital, capital that isn't available today under the current tax laws.

THE COLLAPSE OF THE DOMESTIC INDUSTRY

The domestic oil and gas producing industry is in a freefall state of collapse. Our active drilling rig count crashed the last week of January to 653 rigs, the lowest number since record-keeping began in the early 1940s. And even though the number of active drilling rigs has risen very slightly since, it is still off by more than 300 rigs per week from the same period last year, which had the lowest annual rig count since 1942, when steel was diverted from the industry for the war effort.

The United States is facing a quiet crisis. Quiet because the domestic petroleum industry of the second largest oil and gas producing country in the world is collapsing and few outside the industry know it. If we do not eliminate the tax penalty

on U.S. drilling and return investment capital to this industry, we will lose the infrastructure of an industry which is vitally needed to prevent our nation from drowning in a sea of imported oil.

Let's look at the facts. We now estimate that there are only 8,000 independents in the U.S., down from as many as 20,000 during the early 1980s. We are critical not only because of what we produce but also because we drill about 85% of the exploratory wells and most of the new oil and gas reserves in this country. The number of jobs in our business has dropped by more than 317,000 since the early 1980s; more than 3 times the number of U.S. oil and gas field workers are out of jobs than in the auto industry according to Bureau of Labor Statistics. The economic impact on banks, businesses, and entire communities in oil and gas producing states has been devastating.

As mentioned above, the United States rig count, which is the petroleum industry's measure of drilling activity, dropped recently to the lowest level in recorded history. This is compared to the highest number in 1981 of 4,530. Even more alarming is the fact that in an energy crisis, no more than 1200 domestic rigs could be mobilized due to disintegration of our industry infrastructure and the mass exodus overseas of equipment and talent. To make the point another way, there are fewer rigs available for work today than have been actually working on average over the last four decades!

Oil production in the lower 48 states is at a 40 year low. Since 1985, we have lost of 1.6 million b/d of U.S. crude oil production, or 18 percent of our output. This loss is roughly equivalent to Kuwait's total output before the Iraqi invasion, and we sent 500,000 Americans to fight a war in the desert to prevent Iraqi from gaining control over Kuwait's oil.

Also since 1985, our nation's oil import dependence has increased from 32 percent to nearly 50 percent today. That means 12 supertankers a day entering U.S. ports at a cost of around $146 million a day paid out to the Saudi's and other foreign suppliers. Crude oil imports already account for half of the U.S. trade deficit, an amount which is twice as great as that represented by automobile imports. This dollar drain could triple *to $145 billion per year* in only nine years with oil imports of 10.4 million barrels per day requiring 22 supertankers to sail into U.S. ports each day, according to a recent analysis of a report by your own Office of Technology Assessment.

Only if we can stabilize and renew our rapidly declining domestic oil production and increase natural gas deliverability and consumption, can we prevent foreign oil imports from increasing to levels that will bankrupt the United States. Even at today's relatively low oil prices, every week nearly 1 billion dollars is transferred from the United States to foreign nations to pay for that weeks' worth of imported oil.

There is nothing in sight which can change current trends in time to save our industry except government action to remove the tax penalties placed on drilling by independent oil and natural gas producers. Revival of growth and jobs creation in the independent sector of the domestic oil and natural gas industry must be a part of any economic growth package. This revival can be accomplished by sending a signal to capital markets to erase the red line from oil and natural gas investments in their portfolios, and, to a great extent, this could be done by removing the AMT penalties imposed on the ordinary and necessary business expenses of independent oil and natural gas producers.

THE ALTERNATIVE MINIMUM TAX PENALTY ON DRILLING

The alternative minimum tax (AMT) is a second layer of federal taxation based on a broader definition of taxable income that applies to both individuals and corporations. When the AMT exceeds the regular tax liability in any year, the higher AMT is the tax liability owed. Independent producers, whose ordinary and necessary business are severely penalized under AMT, are increasingly finding that the AMT tax liability is the larger number. This is in large part due to dramatic changes made to the AMT in 1986 as a part of overall tax reform. These changes, enacted to end a perceived abuse that taxpayers were reporting healthy financial earnings, yet not paying any federal income tax, penalize most capital expenditures and particularly singled out natural resource extraction.

Independent producers are not asking for a tax-free business environment; and we have offered recommendations to deal with the "zeroing out" concern that some Senators have indicated that the AMT was intended to address.

Because the AMT can dramatically increase the effective rate of tax, it reduces the return on capital, and makes continued investment more difficult. Across the board, industries dependent on high levels of capital investment for survival are particularly vulnerable to the AMT, especially during times of economic downturn

when profit margins are squeezed. As has been seen perhaps most dramatically in the domestic oil and gas industry, the AMT has spawned a number of surely unintended consequences—including reduced economic growth, declining investment in domestic businesses, and loss of U.S. jobs.

A survey of independent producers clearly shows that the AMT has altered plans for domestic exploration and production and reduced the level of drilling by between 17 percent and 25 percent. In addition, our statistics show that as many as half of the independents not already subject to AMT are carefully limiting their drilling to specifically avoid the AMT. Frankly, that's a smart business decision considering the tax policy, but it is a questionable tax policy that discourages the creation of jobs in domestic drilling and production.

The independent sector of the domestic energy industry is the only industry group that is singled out for special treatment under the AMT. Intangible drilling costs and percentage depletion, analogous to the fully deductible ordinary and necessary business deductions in other industries, are often nondeductible in calculating the AMT. As illustrated in attached Charts 1 and 2, the AMT penalty on drilling costs and depletion increases both the amount of tax and the effective rate of tax imposed on domestic producers, relative to both other domestic industries and to industries overseas. More precisely, the AMT has acted as a cap on the level of drilling that a producer will undertake. As Chart 3 shows, once a producer finds himself facing the AMT, there is no tax benefit and little incentive to invest another dollar in exploring for oil and natural gas. As a direct result of misguided tax policy, investment dollars are redirected to other, often less productive, domestic uses or to foreign treasuries.

Intangible drilling costs (IDCs) are basically the expenditures incurred by a producer to drill a well. This name is misleading because there is nothing intangible about these costs other than the fact they have no salvage value. IDCs include the amount paid to drilling contractors, the cost of other labor, the cost of cementing casing in place, clearing the drill site, building roads, etc.—the costs incurred up until the time the well is capable of production. Many of these expenditures are required to comply with state and federal environmental protection regulations. These costs can equal as much as 80% of the cost of an exploratory well. In today's market, to a great extent because of the AMT penalty outside financing is not available for drilling costs, but must be paid for from the producers' internal cash flow. In fact, in 1990, because of a lack of external capital, internally generated cash and cash from other oil and gas investors accounted for an estimated 80% of the operating funds available to the independent.

The percentage depletion deduction, calculated as a percentage of the revenue from oil and gas (but subject to a number of limitations), allows a producer to recover the economic asset value created through the entrepreneurial risks undertaken in exploring and developing oil and gas reserves—a concept uniquely appropriate in the extractive industries. Percentage depletion is vital to maintaining production from the over 460,000 stripper wells in this country (77 percent of the total number of producing domestic wells). These small oil wells are owned by "mom and pop" independent producers, but collectively they produce over 1,000,000 barrels of oil each day and contain reserves estimated at 3.6 billion barrels of oil. Stripper wells are a valuable and precious resource for our country. If they are abandoned prematurely and the pipe is pulled and sold for scrap and the holes pumped full of cement, these reserves are lost forever.

The full deductibility of IDC and percentage depletion, sanctioned by the tax code for over 60 years, is critical to the independent oil and natural gas industry, where the key to economic survival in a risky, capital intensive business is cash flow. Yet under the AMT, to the extent IDCs exceed 65% of oil and gas income, they are often nondeductible. This is especially detrimental in an industry where producers have traditionally reinvested over 100 percent of oil and gas income in new drilling. In addition, corporate taxpayers are required to make a second adjustment with regard to IDC in the form of the AMT adjusted current earnings (ACE) adjustment. Somewhat perversely, the higher the level of drilling, the more likely a producer is to find himself in AMT. Percentage depletion is also entirely nondeductible under the AMT.

Serious problems demand serious solutions. Without immediate reform of the alternative minimum tax through the elimination of the tax penalties on drilling costs and percentage depletion, a domestic oil and natural gas industry is on its way to becoming a memory and our vast remaining resource base of oil and natural gas will remain undeveloped as our foreign oil imports increase to volumes which threaten the financial system of the United States.

Thank you for the opportunity to deliver this message.

SIMPLIFIED AMT CALCULATION

CHART 1

(Smaller taxpayer at 15% regular corporate rate)

This simplified example illustrates the inequity created when ordinary and necessary business expenses are subjected to IDC and percentage depletion preference treatment under the AMT.

REGULAR TAX CALCULATION	OTHER TAXPAYER	OIL & GAS TAXPAYER
GROSS INCOME	700,000	700,000
ORDINARY & NECESSARY BUSINESS EXPENSES	(650,000)	
IDC		(450,000)
OTHER OIL & GAS EXPENSES		(150,000)
PERCENTAGE DEPLETION		(50,000)
REGULAR TAXABLE INCOME	50,000	50,000
(1) REGULAR INCOME TAX (@ 15% corporate rate)	7,500	7,500
ALTERNATIVE MINIMUM TAX CALCULATION		
REGULAR TAXABLE INCOME	50,000	50,000
IDC PREFERENCE*		76,750
PERCENTAGE DEPLETION PREFERENCE		50,000
ALTERNATIVE MINIMUM TAXABLE INCOME	50,000	176,750
(2) ALTERNATIVE MINIMUM TAX (@ 20% corporate rate)	10,000	35,350
TOTAL TAX LIABILITY (Higher of 1 or 2)	**10,000**	**35,350**
EFFECTIVE TAX RATE	**20%**	**70%**

Note: This example has been simplified for illustrative purposes and ignores, among other things, the ACE adjustment, the special energy deduction, and the $40,000 exemption amount.

TAX LIABILITY HAS MORE THAN TRIPLED!

*IDC PREFERENCE	
(3) EXCESS IDC (IDC IN EXCESS OF AMORTIZABLE AMOUNT)	405,000
NET INCOME FROM OIL & GAS	
GROSS INCOME	700,000
OTHER OIL & GAS EXPENSES	(150,000)
AMORTIZABLE IDC	(45,000)
	505,000
	X 65%
(4)	328,250
(3) less (4)	76,750

SIMPLIFIED AMT CALCULATION

CHART 2

(Larger taxpayer at 34% regular corporate rate)

This simplified example illustrates the inequity created when ordinary and necessary business expenses are subjected to IDC and percentage depletion preference treatment under the AMT.

REGULAR TAX CALCULATION	OTHER TAXPAYER	OIL & GAS TAXPAYER
GROSS INCOME	3,000,000	3,000,000
ORDINARY & NECESSARY BUSINESS EXPENSES	(2,800,000)	
IDC		(2,000,000)
OTHER OIL & GAS EXPENSES		(600,000)
PERCENTAGE DEPLETION		(200,000)
REGULAR TAXABLE INCOME	200,000	200,000
(1) REGULAR INCOME TAX (@ 34% corporate rate)	68,000	68,000
ALTERNATIVE MINIMUM TAX CALCULATION		
REGULAR TAXABLE INCOME	200,000	200,000
IDC PREFERENCE*		370,000
PERCENTAGE DEPLETION PREFERENCE		200,000
ALTERNATIVE MINIMUM TAXABLE INCOME	200,000	770,000
(2) ALTERNATIVE MINIMUM TAX (@ 20% corporate rate)	40,000	154,000
TOTAL TAX LIABILITY (Higher of 1 or 2)	**68,000**	**154,000**
EFFECTIVE TAX RATE	**34%**	**77%**

Note: This example has been simplified for illustrative purposes and ignores, among other things, the ACE adjustment, the special energy deduction, and the $40,000 exemption amount.

TAX LIABILITY HAS MORE THAN DOUBLED!

*IDC PREFERENCE	
(3) EXCESS IDC (IDC IN EXCESS AMORTIZABLE AMOUNT)	1,800,000
NET INCOME FROM OIL AND GAS	
GROSS INCOME	3,000,000
OTHER OIL & GAS EXPENSES	(600,000)
AMORTIZABLE IDC	(200,000)
	2,200,000
	X 65%
(4)	1,430,000
(3) less (4)	370,000

SIMPLIFIED AMT CALCULATION

IDC PREFERENCE AS A CAP ON DRILLING

CHART 3

(Larger taxpayer at 34% regular corporate rate)

Despite the increasing level of IDC expenditures, total tax liability remains essentially the same. The IDC preference acts as a cap on the level of drilling activity because producers will not invest cash in nondeductible expenditures.

	SCENARIO 1	SCENARIO 2	SCENARIO 3
REGULAR TAX CALCULATION			
GROSS INCOME	3,000,000	3,000,000	3,000,000
ORDINARY & NECESSARY BUSINESS EXPENSES			
IDC	(1,800,000)	(2,000,000)	(3,000,000)
OTHER OIL & GAS EXPENSES	(600,000)	(600,000)	(600,000)
PERCENTAGE DEPLETION	(200,000)	(200,000)	(200,000)
REGULAR TAXABLE INCOME	400,000	200,000	(800,000)
(1) REGULAR INCOME TAX (@ 34% corporate rate)	136,000	68,000	0
ALTERNATIVE MINIMUM TAX CALCULATION			
REGULAR TAXABLE INCOME	400,000	200,000	(800,000)
IDC PREFERENCE*	177,000	370,000	1,335,000
PERCENTAGE DEPLETION PREFERENCE	200,000	200,000	200,000
ALTERNATIVE MINIMUM TAXABLE INCOME	777,000	770,000	735,000
(2) ALTERNATIVE MINIMUM TAX (@ 20% corporate rate)	155,400	154,000	147,000
TOTAL TAX LIABILITY (Higher of 1 or 2)	155,400	154,000	147,000

*IDC PREFERENCE			
(3) EXCESS IDC (IDC IN EXCESS AMORTIZABLE AMOUNT)	1,620,000	1,800,000	2,700,000
NET INCOME FROM OIL AND GAS			
GROSS INCOME	3,000,000	3,000,000	3,000,000
OTHER OIL & GAS EXPENSES	(600,000)	(600,000)	(600,000)
AMORTIZABLE IDC	(180,000)	(200,000)	(300,000)
	2,220,000	2,200,000	2,100,000
	X 65%	X 65%	X 65%
(4)	1,443,000	1,430,000	1,365,000
(3) less (4)	177,000	370,000	1,335,000

PREPARED STATEMENT OF FRANCIS M. BATOR

Mr. Chairman, Senator Packwood, Members of the Committee: I am Ford Foundation Professor of Political Economy at the Kennedy School at Harvard. I learned my politics from Lyndon Johnson: during 1965–1967 I served President Johnson as deputy national security adviser with responsibility for American-European relations and for foreign economic policy.

I am honored to be here.

Getting fiscal policy right is never entirely easy. But I believe your current task, Mr. Chairman, is unusually complicated. We are plagued by *two* macroeconomic ailments. They call for *opposite* fiscal actions. And the public believes—mistakenly—that the action that is more immediately needed is in and of itself wrongful.

- The problem for the *long term* is to overcome twenty years of slow growth in productivity and almost no growth in real wage rates. A necessary remedy for that is more investment, both by business and by government—in machinery, in technology, in people. To free up the workers and capacity that will be needed to produce the investment—*once the economy is approaching full employment*—we will have to reduce the relative share of consumption (including defense), that is increase *national* saving. The only reliable method for that is to make the deficit in the federal government's structural operating budget much smaller, indeed, to turn it into a surplus by the end of the decade.
- The problem for the *near term* is to reverse the rise since mid-1990 in unemployment. It has been caused by a still worsening shortfall in total demand relative to potential output. As a result, a large gap has opened up between what we are actually producing and what we can safely produce without speeding up inflation. To make more certain that the gap begins to narrow this summer, we should now take budgetary action to boost demand; perforce, that will make the FY '92 and early '93 budget deficits—but only those deficits—substantially *larger*. (The graph on page 11 shows the gap clearly. Measured at current prices it is now running at about $250 billion per annum, or $3,300 per representative family.)

Curing the long term malady will be both hard and painful; overcoming the immediate problem is both technically relatively easy and the opposite of painful—everyone benefits. But it is politically complicated by the notion that budget deficits are in and of themselves wrongful. That notion is mistaken.

Deficits, even very large deficits, are not bad as such, any more than are taxes or government spending. It depends on the economic situation, and on what effect one wants the budget and money to have on the economy: on total output, employment, and inflation; on how output is divided among consumption and investment, private and public; on the after-tax, after-transfer distribution of income, especially between the poor and the non-poor; and last, on the microefficiency of the economy. Those are the things that really matter. (We sometimes talk as though what mattered was the effect of the economy on the budget. The truth is the opposite. The test of the Federal budget is not what it does to the government's financial situation but what it does, together with monetary policy, to the economy.)

Please don't misunderstand. I believe that the 1984–89 deficits were very bad deficits—they did grave damage. Coming on top of the decline in private saving, excessively stimulative Federal budgets caused public and private spending on consumption to grow much faster than the economy's inflation-safe recovery path. To make room—to prevent an inflationary boom—the Federal Reserve was forced to compress by means of high real interest rates the other two components of spending: domestic investment and net exports. As a result, the share of those wealth-increasing shares fell from over 9% of GNP during 1950–79 to less than 4% during 1982-89.[1]

But for now, with the already large gap between actual output and potential output getting larger, consumption and investment are not in practice rival. As long as there is a large supply of unemployed workers and idle capacity, and inflation is under control, a temporary increase in the deficit and one time jump in the Federal debt need not crowd out either private domestic investment or net exports, and consequently need not impose a significant burden on the future. On the contrary, as long as the Federal Reserve aggressively counters any upward pressure on interest rates, tax-cut induced spending on consumption that improves capacity utilization is likely to give rise to more rather than less business investment.

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[1] That outcome was predictable. I enclose, for the record, a draft OpEd piece I recently found in my files dated 9/10/84 ("Why Vice President Mondale is Right on the Budget, and President Reagan Wrong"). The fifth paragraph predicts that what happened would happen. Many other economists said the same thing.

THE IMMEDIATE TASK

According to the mainline forecasts, the economy will turn up this spring or summer even if we take no fiscal action. That seems to me a good two-to-one, perhaps even three-to-one bet, assuming that the Federal Reserve drives interest rates still lower, and collaborates with the Treasury to flatten the yield curve. But those odds imply a one-in-four chance that the economy will remain flat, or worse, go into a far more dangerous downswing. The longer final demand remains flat, and unemployment and idle capacity keep rising, the greater the risk of stall-out.

I do not think that risk is worth taking. Prudence demands that we take prompt, self-terminating fiscal action designed to produce a first-round increase in total spending on the order of $50–60 billion during the next year (approximately 1% of GNP). Think of it as insurance against a one-in-four chance of continued stagnation, or a nasty second recession. The likelihood that a one year fiscal push of that size would produce an inflationary boom seems to me negligible.

The precise content of a stimulus package matters less than that it be prompt, large enough to matter (though not larger), and temporary. There are many choices. Two months ago, Robert Solow and I suggested one possible program, consisting of an across the board, one-year-only flat percentage increase in all grant-in-aid checks written by the Federal government to the states, cities and localities, and an across the board flat percentage reduction, for one year only, in all Federal income and payroll tax rates. (Today, I'd be inclined to make the sum of the two rather larger than we suggested two months ago.)

But whatever temporary fiscal actions you choose to take, please do so quickly. I would respectfully urge you not to get bogged down in debate about income distribution, tax justice, and who is middle class; it is bound to get in the way of prompt action. After all, the measures would be for one year only; the simpler and more straight-forward the better. The goal is to increase total demand, not to redistribute income or even to try to shift its composition in favor of investment. All that is enormously important, but cannot be well decided quickly, especially in an election year.

I'm afraid the President's program is not that kind of program. So it's up to the Congress. You might even want to make yours a two year program, but stoppable or reducible by a single presidential decision, when he believes that evidence of a turn around is clear and strong. You, the Congress, choose the precise content of the package. He, the President, chooses when to stop within the two year limit. (It would be a useful first step toward removing counter-cyclical fiscal policy that is distributionally neutral from its current straitjacket, and putting both authority and responsibility for it where it belongs: in the Oval Office.)

You are being told not to take short term action that will harm us in the long term. It's a good rule, but I would couple it with another: take whatever action will help in the short term as long as it does not harm us in the long term. The first part says that permanent tax cuts that stimulate consumption are a very bad idea. The second part says that temporary, self-terminating action to stimulate demand in the near term is a good idea.

In a perfect world, steps to boost demand this year would be made part of a decade-long plan of budget tightening and monetary easing designed to reduce substantially the share in GNP of defense and consumption and increase the share of private and public investment, including investment in R&D and education. Restoring the net national saving rate by the end of the decade to what it was during 1950–79 would be a reasonable target. But an election year is not the time to launch such an extraordinary effort.

THE LONG TERM TASK

The attached short article, "Why We Must Raise Taxes" (Challenge, March-April 1990) spells out what I think we need to do over the longer term to make the economy's productive capacity grow faster. Here, I would like to supplement it only as follows:

(1) Absent a fortuitous increase in private saving, merely balancing the government's structural operating budget by the end of the decade will not suffice to restore the national net-worth increasing shares in GNP to their 1950–79 level. To supplement private saving we are likely to need positive Federal saving.

(2) Trying to increase national saving by tax concessions designed to stimulate private saving is a losing proposition. Evidence indicates that the total amount of private saving—the amount of their after-tax incomes that private parties choose not to spend on consumption—is affected hardly at all by changes in the after-tax return to saving. Moreover, most tax measures aimed at boosting private saving will

reduce revenue and thus government saving (measured properly, along a given inflation-safe GNP path). The net result is likely to be a reduction in total national saving—and that is what matters—as well as a more unequal distribution of incomes.

(3) The peace dividend will help. But even a dividend on the order of 3 percentage points of GNP will take us only about half way to the saving we need. To achieve the rest, we will have to cut civilian spending and increase taxes.

(4) In light of that arithmetic, I don't see how we can get away without a substantial increase in taxes. My own preference would be for taxing energy and pollution, and for some kind of value added or national sales tax, carefully tailored to protect the poor. (When thinking about the tax burden, we should remember that the share of all taxes relative to potential GNP in the United States, currently at about 32%, is significantly lower than in any other western industrial country.)

(5) Contriving a large shift from consumption to investment, private and public, is a delicate operation. Budget tightening by itself will only compress demand and free up workers and capacity. To make sure that they are drawn into producing machine tools, bridges, computers for schools, and trained teachers and exports, the Federal Reserve will have to offset budget tightening with still more aggressive monetary easing. Public investment will have to increase. We may even need some carefully pinpointed tax devices for stimulating investment, such as an investment tax credit. (Over the long pull, reducing the capital gains rate will not increase national saving and is in any case a grossly inefficient and inequitable way to stimulate productive business investment.)

(6) When thinking about the long term problem we should keep in mind that we are a very rich country, much richer than in the past, and significantly richer still than any of our richest friends. The notion that we cannot afford to do what we need to do—both here and abroad—seems to me nonsense. In 1990, GNP per family of standard size (3.21 persons) came to about $71,000. Ten years ago the corresponding figure in inflation adjusted dollars was $61,000, twenty years ago $51,000, in 1950 $34,000. The figures for after-tax, after-transfer disposable income were $52,000 in 1990, $44,000 in 1979, and $23,000 in 1950. Personal consumption per family amounted to $48,000 in 1990, $39,000 in 1979, and $21,000 in 1950.

(7) The bad news is that:

- Since 1973 we have not been growing richer fast enough. Moreover, much of the growth we've had has been due to our working more and harder.
- The distribution of income and consumption is extraordinarily uneven, and has become distinctly worse since 1979. Were I to revise the above statement, I would probably list income distribution as our third major problem. But that too is for the longer term.

Attachments.

WHY VICE PRESIDENT MONDALE IS RIGHT ON THE BUDGET, AND PRESIDENT REAGAN WRONG

[By Francis M. Bator, September 10, 1984]

President Reagan says that we need not raise taxes because rapid economic expansion will make the deficit shrink. Is he right?

The President's major premise is certainly right: the faster total spending, and thus output and employment rise—indeed, the faster prices rise—the faster will taxable Income and thus tax revenues increase, unemployment and welfare payments fall, and the deficit shrink. Suppose that the President's minor premise turns out also to be right—the forecast that the economy will continue to expand rapidly. Suppose, in other words, that during the next several years the deficit does shrink rapidly as a result not of legislative action but of continuing rapid economic expansion. Would it follow that the deficit has been harmless and that Vice President Mondale has been wrong to cry wolf?

The opposite is the truth. The faster the deficit shrinks, if that shrinkage is the result not of legislative action but of continuing rapid economic expansion, the more damage the budget will have done.

Paradox? Not once you consider that it is not the effect of the economy on the budget that matters but, rather, the effect of the budget on the economy. The baseline budgets for fiscal years '85–'87 are dangerous precisely because they will tend to make total spending and thus output rise too rapidly, unemployment and idle capacity shrink too rapidly and thus cause wages and prices to reaccelerate. When unemployment was in the 8–10% range, and capacity utilization well below 80%, 6–7% rates of annual expansion in real demand and output were a good thing. But as the unemployment rate drops below 7½% and capacity utilization approaches the

efficient 85%—and if expansion does not decelerate to the 2–3% rate at which the capacity of the economy is growing—the result is bound to be a rekindling of the inflation that we paid such a large price to cure.

Is too rapid economic expansion, a demand driven boom of the sort that caused inflation to accelerate in '65–'69, inevitable unless we take legislative action next winter to reduce the '85–'87 deficits? Not at all: total spending and thus ouput depend both on fiscal and monetary policy. In principle, the Federal Reserve can override excessive budgetary stimulus and prevent a boom. Failing legislative action, the budget will cause the sum of government purchases and personal consumption spending on non-durables and services (driven by rising after tax, after-transfer income), to increase rapidly. But the Fed can keep the lid on total spending by using tight and expensive money to squeeze the other, interest- and credit-sensitive components of spending: residential construction, consumer durable purchases, plant and equipment investment and, through the effect of interest rates on the exchange rate, net exports. If the Fed manages to do that just right, we will avoid an inflationary boom despite the excess stimulus in the budget. Instead, we will have compromised the future growth of the economy's capacity to produce goods and services by reducing the amount of capital formation in housing and plant and equipment and state and local capital, and increased the debt we owe to the rest of the world.

If we do not fix the budget next winter, that is just what the Fed will try to do—prevent a boom by squeezing the components of spending over which it has leverage, and thus make room for the rapid, budget caused rise in government purchases and non-durable private consumption. But for technical if not political reasons, that's a hard act to pull off. Trying to contain a boom by tight money, in the face of a highly expansionary budget, makes for very grabby brakes. Getting the degree of monetary tightness just right is difficult. Aware of the danger of overkill, the Fed may not make money quite tight enough; if so, we will reproduce the '65–'68 demand-pull boom, driven by a very expansionary fiscal policy, insufficiently restrained by tight money. On the other hand, aware of the danger of a reaccelerating inflation, the Fed may step on the brakes too hard causing too large a drop in credit sensitive spending, and produce a recession sometime in late '85–'86. Whatever the outcome, whether the Fed is too loose, overkills or gets it just right we will have an unhappy result: an inflationary boom, a recession, or sustainable growth in the near term with, however, insufficient capital formation, and large amounts of borrowing from abroad.

To improve the menu, we need to take large fiscal action next winter. That need is in no way reduced by the fact that continued expansion—that is, rapid economic expansion faster than the growth in the economy's non-inflationary capacity to produce goods and services—would shrink the deficit rapidly, automatically as it were. The President's economists ought to explain that fact to him. The analytic point is that the actual movement of the deficit is a very poor measure of what the budget is doing to the economy. It is a consequence of what the economy is doing to the budget, as much as a cause.

The question of what kind of legislative fiscal tightening is appropriate remains open of course. In principle, expenditure cuts and tax schedule increases are in this respect substitutes. Here, it is the arithmetic that makes Mondale right and Reagan wrong. Assuming that the Fed avoids both a boom and a recession, and that there is no further budget tightening next winter, 1987 revenues at existing tax rates will fall short of expenditures by about 19%. For good macroeconomic results we should take legislative action to try to reduce that deficit by about 12 percentage points. To bring that about without cutting defense and mandatory entitlements, and without raising tax rates, one would have to cut non-defense discretionary spending—it has already been reduced a lot—from 16% of the budget to less than 6%. Cuts of that sort are not only infeasible but would be undesirable. Indeed, though some economies are to be had, we should increase spending for those categories. Be that as it may, there is no good solution, failing large legislated increases in the tax schedule. Mr. Mondale is dead right when he says that the President ought to be made to face up to that fact and to tell the country how he intends to cope with it before the election.

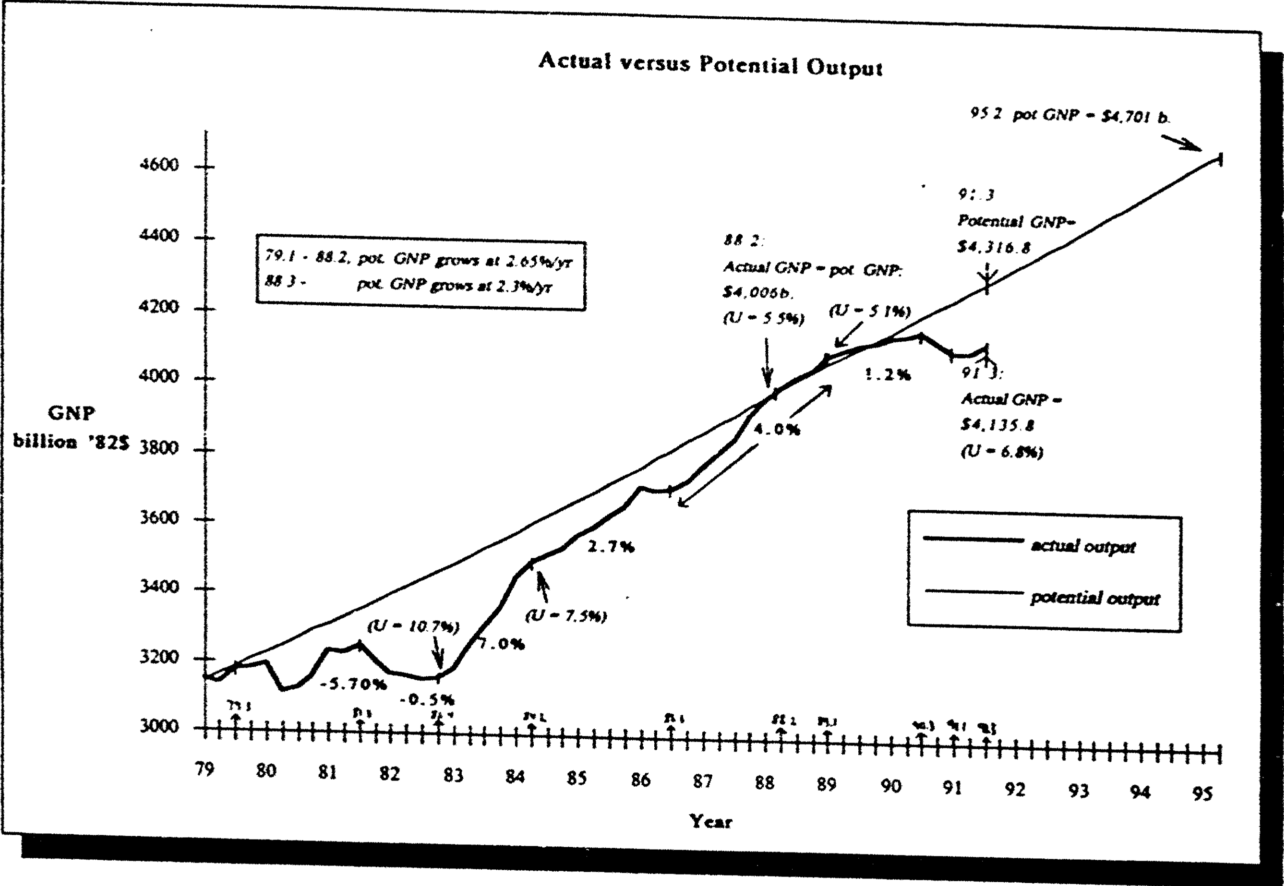

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Table R 16. Current receipts of government as percentage of GDP

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
United States	28.9	28.2	29.3	29.6	30.4	28.8	29.5	29.7	29.9	30.5	30.8	31.6	31.1	30.7	30.7	31.3	31.4	32.0	31.5	31.8
Japan	20.6	21.6	21.5	22.5	24.5	24.0	23.6	24.7	24.5	26.3	27.6	29.0	29.4	29.6	30.2	30.8	31.0	32.6	33.1	33.3
Germany	38.3	39.4	39.8	42.2	42.7	42.7	44.0	45.0	44.7	44.4	44.7	44.8	45.4	45.1	45.3	45.6	44.9	44.4	43.8	44.6
France	38.5	37.7	37.9	37.8	38.4	39.7	41.8	41.4	41.1	42.7	44.5	45.1	45.9	46.6	47.5	47.6	46.9	47.4	46.8	46.5
Italy	30.4	31.1	30.9	30.4	30.6	31.2	32.9	34.3	36.0	35.7	33.0	34.1	35.9	37.7	37.4	38.0	39.0	39.2	39.6	41.1
United Kingdom	40.2	38.3	36.3	35.7	39.6	40.3	39.7	38.9	37.5	38.0	39.9	42.1	42.8	42.1	42.1	42.2	41.2	40.6	40.2	39.7
Canada	34.2	34.7	35.2	34.9	37.2	36.1	35.8	36.1	35.7	35.5	36.2	38.5	39.1	38.7	38.7	38.7	39.5	40.0	40.1	39.6
Total of above countries	30.8	30.6	31.0	31.5	32.7	32.2	32.6	32.9	32.8	33.9	34.5	34.9	35.0	34.7	34.4	34.8	35.2	36.1	35.8	36.0
Austria	39.7	40.5	41.1	41.9	42.5	42.9	42.4	43.7	46.2	45.8	46.4	47.8	46.7	46.4	47.5	48.5	48.2	47.9	47.2	46.1
Belgium	35.2	35.7	35.5	36.4	37.7	45.7	46.2	48.0	49.2	50.2	49.3	50.3	52.4	52.0	53.0	53.2	52.2	52.4	50.6	48.5
Denmark	41.7	46.4	45.9	46.8	48.4	46.1	46.9	47.6	49.6	50.8	52.2	52.1	51.2	53.6	55.5	56.5	58.3	58.8	58.6	57.4
Finland	34.1	35.7	35.4	36.0	35.7	37.8	41.0	40.4	38.0	36.1	35.8	37.5	37.3	37.4	39.0	40.5	41.8	39.7	40.0	39.9
Greece	26.8	26.6	26.6	25.4	27.0	27.4	29.5	29.9	30.1	30.6	30.5	29.1	32.3	33.6	34.8	34.6	35.6	36.5	34.0	31.8
Iceland	30.9	32.6	34.5	34.2	34.1	34.0	33.0	31.3	31.6	32.7	33.3	33.9	35.6	33.5	34.0	32.5	32.1	32.1	35.4	36.6
Ireland	35.3	36.3	34.9	34.5	35.2	34.6	37.9	36.4	35.2	35.9	38.8	39.6	41.9	43.6	43.8	43.6	43.5	43.8	44.9	..
Luxembourg	35.4	38.4	38.5	39.0	40.2	48.6	50.2	54.2	55.2	52.1	53.3	53.8	53.8	56.2	54.2	55.9	52.9	..	..	..
Netherlands	42.0	43.3	44.5	45.9	47.0	49.2	49.5	50.5	50.9	51.4	52.8	53.5	53.8	55.3	54.1	54.3	53.0	53.6	52.4	50.1
Norway	43.5	46.6	48.4	49.6	48.5	48.7	49.8	50.0	50.8	50.8	53.2	51.8	51.9	51.8	53.0	55.1	54.7	55.2	55.1	54.9
Portugal	24.3	23.5	23.4	22.7	23.0	24.8	28.1	30.5	29.5	30.0	31.4	33.3	35.4	37.8	37.3	35.9	37.6	36.2	38.1	38.7
Spain	22.5	22.6	23.0	23.7	22.8	24.3	25.3	26.5	27.1	28.4	29.7	31.2	31.4	33.5	33.2	34.2	34.7	36.4	36.3	.
Sweden	46.6	49.4	49.5	47.7	48.8	50.5	55.1	58.0	57.5	56.4	56.3	57.6	58.0	59.6	59.2	59.5	60.4	62.3	61.8	64.1
Switzerland	26.5	26.2	26.4	28.8	29.7	32.1	33.9	33.7	33.8	33.1	32.8	32.8	33.3	33.9	34.7	34.4	35.0	34.5	35.0	34.1
Turkey	23.7	23.7	27.1	..	..	..	.	.	.	.	..	.	..	..	..	..	..	..	..	..
Total smaller European countries	34.8	36.0	36.3	37.2	37.5	39.7	41.4	42.6	42.8	42.7	43.4	44.0	44.2	45.5	45.8	46.4	46.4	46.8	46.2	48.2
Australia[a]	26.6	27.3	25.2	26.7	28.5	29.0	29.7	30.1	29.0	29.8	30.7	31.7	32.3	31.5	33.3	34.0	34.9	34.6	34.4	34.2
New Zealand	..	..	..	..	.	.					..	.	..	..	..	..	..	..	..	.
Total smaller countries	33.6	34.8	34.8	35.5	36.1	38.1	39.7	40.9	41.0	41.1	41.8	42.1	42.3	43.1	43.5	44.4	45.0	45.3	44.5	45.6
Total OECD	31.1	31.1	31.5	32.1	33.2	33.1	33.8	34.2	34.1	35.0	35.7	36.0	36.0	35.8	35.6	36.0	36.5	37.3	37.0	37.1
Four major European countries	37.3	37.3	37.0	37.8	39.0	39.5	40.8	41.2	41.0	41.3	41.5	42.3	43.1	43.3	43.5	43.7	43.4	43.3	42.8	43.2
OECD Europe	36.6	36.9	36.8	37.6	38.5	39.6	41.0	41.6	41.6	41.7	42.1	42.8	43.4	44.0	44.2	44.5	44.3	44.3	43.8	44.5
EC	36.5	36.6	36.4	37.2	38.1	39.1	40.4	41.0	41.0	41.3	41.6	42.3	43.1	43.7	43.8	44.1	43.8	43.9	43.3	43.9
Total OECD *less* the United States	33.1	33.6	33.2	33.8	35.1	35.8	36.5	37.0	36.5	37.5	38.3	38.7	39.4	39.4	39.5	39.9	39.7	40.3	39.9	40.2

Source: *National Accounts* (annual OECD publication). The data in this table are measured according to the standard definitions of the OECD United Nations system of accounts (See *A System of National Accounts*, Series F, No. 2, Rev. 3, United Nations, 1968.)

Percentages for country groups: The percentages tages for each group of countries are calculated from the total GDP and current receipts of government for the group, with both aggregates expressed in US dollars at current exchange rates. Percentages for country groups exclude countries for which no data are shown in the table.

Current receipts of government mainly consists of direct and indirect taxes, and social security contributions paid by employers and employees. It is given on line 21 of Table 6 (Income and outlay account) of National Accounts, Volume II, Detailed Tables.

a) Fiscal years beginning on 1st July.

VIEWPOINT

Why We Must Raise Taxes

Net national saving and investment by Americans—what we devote to increasing our net worth in the form of business plant, machinery, and inventory, housing, public civilian infrastructure, and claims on the rest of the world—fell from 9 percent of GNP during 1950-79 to 2.7 percent during 1982-88. During 1950-79 it never once fell below 6 percent.

The shortfall in national investment, and *not* the trade deficit, is our major resource allocation problem. Had we offset the growth in America's foreign debt by enough extra *domestic* investment in productive plant and equipment—had *total* national investment by Americans, domestic plus foreign, been sufficient—the inflow of foreign capital and the associated trade deficit would have been a bargain.

Insufficient investment will not by itself cause an action-forcing crisis But it will cause a gradual slowdown in the growth of national income. Imperceptible year by year, the cumulative effect on the quality of American life would be profoundly harmful. With not enough new wealth to go around, any one person's gain would have to come increasingly from other people's losses. Conflict over the distribution of wealth could easily become our main political preoccupation.

Increase national saving

To make room for enough investment—public and private, hard and soft (to support research and education)—we must sharply increase *national* saving, the combined total of private saving and government saving. Government saving consists of the operating budget surpluses of all levels of government; government operating deficits constitute dissaving, a subtraction from national saving. The only reliable method for increasing national saving is to increase federal government saving. That means gradually shifting the government's structural operating budget—what the budget would be at high employment, including social security, but excluding federal civilian investment—from a large deficit to a large *surplus*.

Trying to increase national saving by tax concessions designed to stimulate private saving is a losing proposition. Evidence indicates that the total amount of private saving—the amount of their after-tax incomes that private parties choose not to spend on consumption—is affected hardly at all by changes in the after-tax return to saving. Moreover, most tax measures aimed at boosting private saving will reduce revenue and thus government saving (measured properly, along a given inflation-safe GNP path). The net result is likely to be a reduction in total national saving, as well as a more unequal distribution of incomes.

Suppose we wanted national investment to regain its 1950-79 share of 9 percent of GNP by the mid-1990s. Barring a large *spontaneous* jump in private saving, we would have to shift the government's structural operating budget from a deficit measuring 2.9 percent of GNP in 1988 to a *surplus* by the mid-1990s on the order of 5 to 6 percent! Merely balancing the federal budget would not restore national saving. To supplement meager private saving, we need *positive* federal saving.

I do not say that a 9 percent investment share is the right target. But unless we are willing to hobble along with much less investment than during 1950-79, the conclusion is hard to escape: *We have to raise taxes*. Even heroic cuts in defense and entitlements will not yield enough federal saving soon enough to make room for anywhere near enough national investment. (The President's "flexible freeze" would result in grossly insufficient investment for at least another decade.)

Reduce interest rates

For more investment, tightening the budget is a necessary but not a sufficient action. By itself, it will serve only to reduce personal consumption and government purchases, thus freeing up resources: workers and capacity. Drawing those resources into producing capital goods and exports—avoiding a recession—will require aggressive Federal Reserve action to drive down interest rates, a liberal investment tax credit, and more public investment. Real interest rates would have to be driven much lower, both to encourage domestic investment and to cause the dollar to become cheap enough to induce foreigners and Americans to switch more of their spending from foreign goods to American goods. To keep such switching from causing a recession abroad, foreign governments, especially the Germans and the Japanese, would have to take expansionary fiscal action.

Cutting the U.S. capital gains tax would not help. Over time it would reduce revenue and government saving, have little effect on private

saving, and thus would almost certainly *reduce* national saving. Moreover, it is a notably cost-ineffective method of stimulating productive new business investment. It would encourage real estate speculation.

Responsibility for the collapse of national saving and investment falls squarely on the federal government Statistically, the decline in private saving has accounted for about half of the collapse in national saving. But the federal government could and should have offset falling private saving by increasing federal saving, that is by running a large structural operating surplus. It did the opposite. If you turn the steering wheel of your car sharply to the right when the road is clearly turning to the left, to say that the road made the car crash is missing the point.

Since late 1983 the Federal budget has been much too stimulative. Sharply rising government noninvestment purchases and transfer payments, and insufficient taxes—all in the face of a falling private saving rate—have caused public plus private spending for consumption to grow much faster than inflation-safe GNP. To prevent an inflationary boom—to keep total spending on American goods within the inflation-safe capacity of the economy—the Federal Reserve has had to use high real interest rates to "crowd out" the other two components of spending on U.S. goods: domestic investment and net exports (the proceeds of which go to increase American ownership of claims on foreigners)

That more net exports were crowded out than domestic investment—that net foreign investment by Americans was hurt more than domestic investment—was coincidental. Had foreign money been less attracted by the high interest rates available in New York, the exchange rate would have risen less, but U.S. interest rates would have risen even more. As a result, net exports and thus net foreign investment by Americans would have suffered less, but domestic investment would have suffered more.

GNP budgeting

The good news is that even an ambitious program for increasing investment need not be very painful. For example, even without cutting defense—and without any improvement in the sluggish 2.5 percent per year pace at which potential, inflation-safe GNP has been growing recently—we could restore the national investment share in a half dozen years to what it was during 1950-79 and increase public services in step with potential GNP, without ever having to reduce the real personal consumption of a representative family of 3.21 people below the roughly $45,000 that it is now. If Mikhail Gorbachev does what he says he will do—if we can cut defense safely by more than we need to increase spending on the poor, on public services, and to support a forward-looking foreign economic policy—we can do even better.

The reason is that we are a rich country: GNP per representative family exceeds $67,000. But to maintain the vigor of our own society, and to keep playing our part in the world at large, we need to become better-off still, and that will take more investment. For that, we have to increase taxes, not to provide the government with money to pay its bills, but to hold down taxpayers' spendable incomes and consumption and thus to free up enough workers and capacity to produce the additional investment.

In comparison with the rest of the industrial world, we are an undertaxed nation. Relative to gross domestic product, the current receipts of all levels of government in 1987—the last year for which comparable figures are available—measured 32 percent in the United States, 33.2 percent in Japan, 34.5 percent in Switzerland, 39.5 percent in Canada, 40.7 percent in the United Kingdom, 44.4 percent in West Germany, 47.6 percent in France, and 62.7 percent in Sweden.

Taxes are not good or bad as such, any more than are government spending, deficits, debt, high or low interest rates, and a cheaper or dearer dollar. They are good or bad according to what effect we want the budget together with monetary policy to have on total national output, employment, and inflation; on the division of output among personal consumption, public services, and private and public investment; and on the distribution of income after taxes and transfers, especially between the poor and the rest of us. Those are the things that really matter.

In our political debates about economic policy we typically ignore those large questions of GNP budgeting and argue instead about taxes, government spending, and interest rates in no relation to what allocation of the GNP we want those policy instruments to achieve. Yet there are real choices to be made here, choices not about deficits, or debt, or taxes, but about the best use of our scarce labor and material resources.

Opinions will differ about the best choices; that is what makes the problem political rather than merely technical. Helping to form, compare, and compromise such opinions is the task for political leadership at its highest. Unless our elected leaders take the trouble to understand what these choices are, and have the courage to help explain them to the rest of us, we will continue to make them blindly and get what we want only by chance.

FRANCIS M BATOR
Ford Foundation Professor
of Political Economy
Kennedy School of Government
Harvard University

PREPARED STATEMENT OF THOMAS M. BLOCH

Mr. Chairman and members of the Committee, my name is Thomas M. Bloch, President and Chief Operating Officer of H&R Block, Inc. I appreciate the opportunity to appear before you today to present H&R Block's views on the tax burden of middle income taxpayers.

H&R Block is headquartered in Kansas City, Missouri and is the nation's largest income tax preparation service. We have close to 9,000 company-owned and franchise offices worldwide employing over 56,000 people during the tax filing season. Last year we prepared 11.7% of all individual U.S. tax returns for a total of over 12 million returns. In addition to our U.S. operation, we have offices in Canada and 13 countries overseas.

We have been serving America's taxpayers since 1955 when my father, Henry Bloch, and his brother founded the company. I am here today because the vast majority of our customers are middle and lower income taxpayers. We have more experience working with and listening to middle and lower income taxpayers than anyone else. As a result, we are in a unique position to learn of the practical problems and concerns faced by America's taxpayers.

What we have found over recent years is a growing sentiment by middle America that they are not being treated fairly by the federal tax code. Increasingly they tell us that they are paying more than their fair share and they feel frustrated and angry about that. Our customers have expressed their concern that they were left out of the boom years of the 1980's. They perceive, and studies support this perception, that the rich experienced no significant adverse effect from tax legislation enacted during these years, and in fact, may have gotten richer because of it.

Our clients feel that this same tax legislation, in particular, the Tax Reform Act of 1986, increased their tax burden. They point to the elimination of the deductions for personal interest and sales tax, as well as the restraints on deductions for medical, job related, and moving expenses, as contributing to this burden. Our customers know we strive to provide more than quality tax preparation services -- they know we are equally committed to listening to their concerns, and in turn using our expertise to help them get a fair shake from the federal tax system.

CHANGING THE WITHHOLDING RATES

Before addressing the need for middle income tax relief, I would like to talk about the recent change to lower the withholding rates. In his State of the Union address, President Bush announced that one of the keystones of his economic recovery proposal was to lower the withholding rates so taxpayers will have less withheld from their paychecks this year. This is not a tax cut, but merely puts a few extra dollars into taxpayers' pockets now rather than allowing them to receive a large lump sum refund payment next spring. Under the new tables, single taxpayers receive on average an additional $3 per week in their paycheck. However, this means that tax refunds for single taxpayers will be reduced by approximately $172 next year. Married taxpayers who both work and who file jointly will receive $690 less next year. Since the average refund is over $900, we know that many taxpayers are going to be unpleasantly surprised to discover next year their refund is substantially lower, or that they owe money to the IRS.

A NEW PAPERWORK AND COST BURDEN

A major concern for us is the fact that this action has created a new paperwork burden of needless complexity for taxpayers

as well as for employers, and an additional cost to the federal government. The fact is that this change creates an inconvenience for our customers who must take action if they want to get the same refund amount next year. We know they have had the choice over the years to file new W-4s so they could have less withheld -- the fact is they didn't do it. Now, those same taxpayers who have shown their acceptance of the current system, must take the steps to keep the status quo. Those new W-4s create an additional paperwork burden for taxpayers, their employers, and for the IRS.

POTENTIAL COMPLIANCE PROBLEMS

Another issue you should be aware of, is the potential compliance problems that could be created by reducing, and in some cases eliminating, taxpayers' refunds. This is not a business concern for H&R Block, but will be a problem for the IRS. If, for example, certain taxpayers expect to owe taxes, instead of receive a refund, they may be less inclined to file a tax return next year. Consequently, the IRS will have their workload increased because they will have to identify and locate these new tax avoiders. This is a very real possibility which will create unanticipated problems and an additional burden for the IRS.

TAXPAYERS LIKE REFUNDS

We have found over the years that most of our customers like getting refunds. In fact, nearly 70% of all taxpayers get a refund. For many of them, their federal tax refund is their preferred savings program, one they believe they would be unable to manage otherwise. In order to help our customers adjust to this new action, we are now offering free preparation of their W-4 forms so they can continue their withholding at the same level. This free service is available to all taxpayers, whether or not they are Block customers. We hope this move will help those taxpayers who otherwise would be very disappointed next year to find out they cannot afford a major, consumer purchase like a new appliance or a downpayment on a new car.

As stated previously, taxpayers have had the choice for years to have less withheld, but they did not do it. They prefer the forced savings program that their tax refund provides. Is it right, then, for the government to automatically cut the amount of withholding without first asking the taxpayer if this is what he or she wants?

WHY MIDDLE INCOME TAX RELIEF IS NEEDED

Reducing refunds is not going to solve the real problems faced by America's middle and lower income taxpayers. Study after study has shown that middle income taxpayers are justified in feeling unfairly taxed. For instance, the Congressional Budget Office released a comprehensive study last year which looked at the entire spectrum of federal taxes and found middle income taxpayers now pay a higher share of their income in overall federal taxes than they did before the tax breaks enacted in 1978 and 1981. In fact, according to CBO figures, the top 1% of taxpayers will pay on average $83,457 less in overall federal taxes in 1992 than they paid in 1977 (includes personal and corporate income, social security and excise taxes). At the same time, the middle 20% of taxpayers will pay an average of $280 more in overall federal taxes in 1992 than they paid in 1977 (these figures reflect income shifts and inflation).

These figures are troubling -- troubling enough that we have commissioned our own study to further investigate the shifting tax burden on middle income taxpayers. The results of that study should be available later this month.

WHAT TO DO ABOUT PROVIDING TAX RELIEF

What can Congress do to provide tax relief to middle income taxpayers? I would like to talk about the direction that Congress [illegible] as well as some specific changes that can be made.

Last year, members of Congress responded to the [illegible] of America's taxpayers by introducing one proposal after another to provide a [illegible] variety of tax relief to middle income taxpayers. We applaud your efforts to address this major issue and provide a forum for public debate on the possible courses of action. [illegible], the big questions become what type of relief to provide and [illegible]

[illegible] the proposals being considered are broad initiatives to stimulate the economy and go beyond issues of middle income tax relief. My remarks today will focus on those proposals directed to providing tax equity for low to middle income taxpayers. In general, the proposals under consideration offer 3 different types of relief:

1. Tax Credits: These proposals vary and include nonrefundable tax credits for children (Chairman Bentsen's bill, S.1921); refundable tax credits for children instead of the personal exemption (Gore/Downey, S.955 & HR.2242); refundable tax credits for young children (Coats/Grassley/Wolf, S.1009 & HR. 2633); and Rep. Rostenkowski's bill, HR.3730, to provide refundable credits up to 20% of Social Security and Medicare payroll taxes.

2. Increasing the Personal Exemption: These types of proposals include President Bush's proposal to increase the personal exemption for children by $500, Rep. Wolf's bill, HR.1277, to increase the dependent deduction for children from $2,150 to $3,500. Representative Schroeder has introduced a similar measure, HR.3148, which also adds a new 36% rate for individuals and a surtax on high income taxpayers.

3. Liberalizing IRAs: These types of proposals allow IRAs to be fully deductible for all taxpayers and allow taxpayers to make penalty-free withdrawals from IRA funds for home purchases, tuition and medical costs (Chairman Bentsen's bill, S.1921)

Mr. Chairman, we have studied your proposal, S.1921, and believe it is well intentioned and a step in the right direction, because it strives to offer tax relief to a range of taxpayers through a child tax credit and by loosening restrictions on IRAs. We recommend that the tax credit be refundable and perhaps not limited to just children. H&R Block supports enacting a tax relief package that will benefit the largest cross-section of low to middle income Americans -- a tax package that will work to restore tax equity to the federal tax system.

What we have found in our experience as America's largest tax preparation business is that tax credits that are refundable will benefit the largest number of taxpayers in an equitable way. The advantage of refundable tax credits is that lower income taxpayers would get some relief, as compared to nonrefundable tax credits which shut out lower income taxpayers. Ideally, these would be tax credits which are not limited to families with children, but which

BEST AVAILABLE COPY

would be available to all lower and middle income taxpayers, regardless of their family size or situation. For instance, it would help young single or married taxpayers (with no dependents) who may be struggling to purchase a home or save money so they can afford a family.

Refundable tax credits would also help older, lower to middle income taxpayers whose children are grown or who may need to save for their retirement. This group of older taxpayers often cannot take advantage of itemizing because their homes are paid for, and they are too young to take advantage of deductions and/or credits for age.

We prefer refundable tax credits over increasing the personal exemption for children. Increasing the personal exemption for children has merit, but most proposals would provide the largest dollar benefits to upper income families with children. Adjusting the amount of increase in the personal exemption so it is greater for those in the lower income brackets would help to provide some equity to this type of benefit. However, it still limits the much needed relief for those in the lower and middle income brackets to a smaller segment of these taxpayers, namely those households with dependent children.

Liberalizing IRA's is of some interest to Block's customers. However, many of our customers do not have the resources to invest in IRAs and consequently could not take advantage of the opportunities for penalty-free withdrawals. Additionally, we have concerns about allowing full deductibility for IRA's, since it will generally benefit only upper income taxpayers (under current law, couples covered by their employers' pension plan who have AGI's over $40,000 cannot fully deduct their IRA contributions).

While my focus today is on proposals to help middle and low income taxpayers, I do not believe it is unreasonable to pay for such tax relief by increasing the tax rates on wealthy taxpayers, the same class of taxpayers who received the greatest benefits from tax cuts in the 1980's. In particular, proposals to impose a surtax on million dollar incomes and/or create a new tax rate for wealthy taxpayers merit your serious consideration.

MODIFICATION OF THE EARNED INCOME TAX CREDIT

Now, I would like to move to another topic and briefly discuss changes to the Earned Income Tax Credit. Last year, an estimated 1.6 million of our customers claimed the earned income tax credit. We understand and support the intent of Congress in 1990 to expand the earned income tax credit. Last year we submitted comments to the IRS when they released the new draft form for EIC making our recommendations on how to improve the form and instructions to meet the new requirements. Now, we are in the middle of the tax filing season and can see first hand that the only effective solution is to modify the credit by repealing the provision that links the ability to claim the "wee tot" and health insurance credits to other tax benefits. We also support other provisions under consideration to increase the basic credit amount and to increase the family size adjustment.

CONCLUSION

I would like to close my remarks today by saying that H&R Block firmly believes that middle and lower income taxpayers deserve a break in the federal tax code. Specifically, we recommend tax relief in the form of refundable tax credits to provide relief to the greatest number of middle and lower income taxpayers. We have witnessed firsthand our customers growing unhappiness with their current federal tax liability, their

declining confidence in the economy, and their very real concern that their economic future is at risk for them and for their children. Providing tangible tax relief to middle and lower income Americans, not just tax gimmicks, will go further to restore confidence in the economy than anything else you do this year.

Mr. Chairman, we would be happy to provide any assistance to you as you consider middle income tax relief. As I stated earlier, we have more firsthand experience with middle income taxpayers than anyone else and naturally have extensive expertise and information we can offer to assist you and the rest of the Committee during this debate. Thank you for allowing me to appear before you today. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF MICHAEL J. BOSKIN

Chairman Bentsen, Senator Packwood, and other distinguished Members of the Committee, it is a pleasure to appear before you today to discuss the Administration's economic outlook and programs, and their relation to the budget.

The United States is the most prosperous and productive Nation on earth. With less than 5 percent of the world's population, America produces a quarter of the world's total output. However, no economic system is immune to disruption. Even well-functioning market economies face the risk of temporary setbacks from external shocks, policy mistakes, or other disturbances. This was starkly demonstrated in the first 2 years of the 1990s. The American economy, which already was experiencing slow growth, fell into recession in the second half of 1990. Between the third quarter of 1990 and the first quarter of 1991, output fell 1.6 percent and 1.7 million jobs were lost. Growth resumed in the second and third quarter of 1991, but at a sluggish pace. Real GDP was essentially flat in the fourth quarter. The recession and very sluggish growth reflect the serious difficulties that the U.S. economy has faced in correcting structural imbalances while adjusting to previous monetary tightening, the credit crunch, and the August 1990–January 1991 oil shock.

Structural imbalances had developed in the financial and real estate sectors, in household and corporate debt positions, and in governments' fiscal positions. A major reallocation of resources from defense to other sectors is under way, reversing the trend of the 1980s. The economy also has had to deal with changing national demographics, and a productivity growth slowdown that began two decades ago.

The monetary policy initiated in the late 1980s to ease incipient inflationary pressure slowed growth beginning in 1989. The anticipated increase in demand for world capital resulting from the historic changes in the former Soviet bloc, especially the unification of Germany, increased interest rates substantially in early 1990. Problems in financial markets have limited the availability of credit.

The other industrial countries also were buffeted by many of the same problems that hit the United States—the oil shock, sinking consumer and business confidence, and high interest rates. Several of these countries also were experiencing structural problems related to government budget positions and serious difficulties in their financial and real estate markets. Recessions began in Canada and the United Kingdom earlier in 1990, and with jobless rates at or exceeding 10 percent in late 1991, the recessions have been deeper than in the United States. Growth in other industrial countries, including France and Italy, slowed in 1991, and the unemployment rate for the European Community as a whole was about 9 percent in 1991. Growth in Japan and Germany slowed considerably in the second half of 1991.

The current economic difficulties in the United States and other industrial countries should not obscure the fundamental strengths of market economies. The United States is the world's best example of the interrelated strengths of democratic pluralism and market-oriented economies. Americans have the highest standard of living in the world. U.S. gross domestic product (GDP) per capita of $22,056 in 1990, the latest year for which comparable data are available, places the United States more than 35 percent above Germany and more than 25 percent above Japan, when calculated using purchasing power equivalents. The United States has the highest level of productivity of any country in the world, with output per worker about 20 percent above the average of the other major industrial countries. As of 1990, the last year for which comparable data are available, the United States produced a larger share of the industrial output of the Organization for Economic Cooperation and Development—24 of the largest industrial economies—than it did in 1970.

Modern market economies such as the United States are constantly restructuring in response to changes in the goods and services that consumers desire, innovations in productive technologies, and external events that affect the ability of the economy to produce goods and services. In the last decade, for example, computer technology has transformed the workplace and greatly increased the demand for skilled workers.

In responding to structural change, however, even a fundamentally sound market economy can occasionally develop imbalances. Or external shocks or policy mistakes can knock it off track. A flexible and productive economy generally can adapt to such events with a minimal amount of disruption to the economy as a whole, although the costs of adjustment usually are concentrated in specific groups of the population or regions of the country. But if an unusual confluence of imbalances, mistakes, and shocks occurs, then the self-adjusting mechanisms may be inadequate to sustain overall economic growth. And if productivity growth is slow, the economy has less of a cushion to absorb the adjustment that markets undertake naturally without sliding into recession. The American economy is struggling today with such a confluence of events.

For the year and a half prior to the recession that began in the third quarter of 1990, the U.S. economy was growing at only a 1¼-percent annual rate as it adjusted to policies and worked to correct its imbalances. When the recession began, the Administration and most private analysts believed that it would not be as severe as the last recession, or even the average of postwar recessions. Partly as a consequence of expecting a less severe recession, the subsequent recovery also was expected to be more moderate than those following other postwar recessions. Moreover, many, including the Administration, believed that the continuing resolution of structural imbalances would lead to a slower than average recovery.

The recession appeared to end in the spring of 1991, and signs of a moderate recovery began to emerge. The index of leading indicators, industrial production, real income, and retail sales all bottomed out in the first quarter and showed upward trends into the second quarter. Other key data also pointed to a recovery. Housing starts, new orders for durable goods manufactured in the United States, and manufacturers' shipments reached their recession troughs in the first quarter and then climbed through midsummer. Real GDP grew modestly in the second and third quarters of 1991.

Rather than continuing its modest rebound, the economy flattened from the late summer to the end of 1991. Payroll employment, industrial production, and retail sales all turned down. Real GDP was essentially flat in the fourth quarter. On the positive side, exports continued to rise and housing starts continued their slow upward progress. The Administration, along with most private analysts, expect the economy to be sluggish early in 1992 but then to pick up in the second half of the year. Some indicators of future economic activity reinforce this view.

Fundamentals that promote growth are beginning to fall into place. Declining real and nominal interest rates should help boost interest-sensitive spending. Inflation, too, is expected to remain near its current, relatively low levels. Imbalances in international accounts have been substantially reduced, and exports should continue to grow as the Nation's international competitive position strengthens. Some structural imbalances are being righted: Households and corporations are reducing their credit burdens, and banks are improving their capital positions. It will take time to correct all the imbalances, but a start has been made.

With the exception of a few industries, there does not appear to be a widespread inventory imbalance that would foreshadow further cuts in production. Increases in domestic and foreign demand will therefore be met mainly from new production and not from drawing down existing stocks. New production will generate income, increase consumption, and lead to further gains in production, employment, and income.

The international competitive position of the United States has improved. After adjusting for exchange rates, the pattern of unit labor costs in manufacturing has been favorable relative to that of the Nation's major trading partners. As foreign economic growth rebounds, U.S. exports should increase.

A particularly positive factor is the reduced inflation rate. Although special factors in agriculture, energy, and excise taxes may cause an occasional temporary blip in, for example, the consumer price index, underlying inflation is widely believed to be down. The economy currently is operating well below full capacity. Thus, during a moderate recovery, resource constraints that could rekindle inflationary pressures are unlikely to emerge. Furthermore, a credible and systematic monetary policy that is designed to reduce inflation gradually has ample room to accommodate a healthy expansion.

Nominal interest rates generally are at their lowest levels in two decades. Real rates may not be as low as they have been around the trough in some other cycles. But the lagged effects of lower interest rates already in the pipeline should help the economy in 1992. The lowest mortgage rates in almost 20 years should spur housing starts and sales. Low rates also allow households to refinance mortgages, improving their balance sheets and providing a foundation for consumption growth. For many businesses, lower interest rates reduce the cost of borrowing to finance new investment. They also increase corporate cash-flow. Some corporations are using the strong stock market to issue equity and repay debt, thus improving their financial position and freeing funds for investment. There is some offset to the expansionary effect of these factors because lower interest rates reduce interest income and the consumption based on it.

Because their capital positions have improved greatly, banks should be in a better position to lend than they have been for some time. Furthermore, the Administration, under the leadership of the Treasury Department and in conjunction with banking and thrift regulators, has been working to ensure that lenders make prudent loans and that examiners perform their reviews in a balanced, sensible manner. Still, bank lending remains tight; many banks are investing in Treasury securities rather than making loans. A combination of slack demand, due to the soft economy and the need to rebuild balance sheets still further, and skittishness, in response to regulatory overreaction, is preventing the banking system from playing its normal role in financing economic expansion.

The Administration forecasts real GDP to grow 2.2 percent in 1992 and 3 percent in 1993 if the President's policies are adopted. The unemployment rate may rise slightly early in the year, but if the President's policies are enacted, should start to decline thereafter. Inflation and interest rates should remain relatively low. If the President's proposals are not enacted, the economy is less likely to improve and the improvement is likely to be slower and weaker.

Table 1 compares the Administration forecast to that of the CBO and the so-called Blue Chip consensus—actually the average of the 52 private Blue Chip forecasters. As was the case last year, the CBO is somewhat more optimistic about real growth than the Administration. The Administration outlook is slightly below the Blue Chip average real GDP forecast. By way of comparison, summing the forecast errors for 1991 over real growth, unemployment, inflation and interest rates, only 8 of the 49 Blue Chip private forecasters (3 did not forecast all variables) were more accurate than the Administration. The Administration also was more accurate than the CBO. But the differences were modest. Virtually none of the private forecasters predicted the flattening out in the latter part of the year. CBO had real growth of about 3 percent for the second half; the Administration 2.4 percent; the Blue Chip average was 2.2 percent.

These developments serve to remind us all of something I say each time I deliver the economic outlook and that is well to bear in mind. Economic forecasting is an imprecise science. Unexpected events and policy changes can cause actual events to be substantially different from the forecast, and forecasts are based largely on predictions about human behavior, usually taking previous patterns of behavior as a guide. But human behavior is complex, difficult to predict, and subject to change. People do not always respond the same way, or with the same speed, in what appear to be similar circumstances. Hence, there remains some uncertainty about the outlook for the economy.

If the problems the economy has been facing are resolved relatively quickly and confidence is restored, growth could rise faster—and to a higher rate—than is expected. The relatively low rate of inflation combined with the large degree of slack in the economy is particularly noteworthy, as it could allow the Federal Reserve to keep interest rates low—or cut them further if necessary—to help boost growth with little immediate concern about reintroducing inflation pressures. A quick shift to a significant rebuilding of inventories alone could add a percentage point or more to the rate of growth over the next year. Alternatively, if the problems are solved very slowly, the economy could perform worse than expected. Tight credit and slow money growth, along with the continuing structural adjustments described earlier could continue to hinder the economy, and under those conditions confidence could remain low and the rate of growth likely would be lower than expected.

The President has presented a comprehensive and coordinated growth agenda for the Nation. The agenda includes fiscal and other measures that will make near-term recovery faster, stronger, and more certain, while solidifying the foundation for long-term growth to help ensure that the United States remains the world's leading economy in the 1990s and beyond.

The Administration's policies for raising long-run productivity growth and thus the standard of living are based on five principles: a pro-growth fiscal policy that

enhances incentives for entrepreneurship, saving, and investment, in the context of the final discipline necessary to slow the growth of spending to reduce the multiyear structural budget deficit; a trade policy that promotes growth through opening markets worldwide; a regulatory policy that avoids unnecessary burdens on business and consumers; a human capital investment policy that focuses on education, training, and preventive health care; and strong support of a monetary policy that keeps inflation and interest rates low, while providing adequate growth of money and credit to support solid real growth.

The short-term agenda includes executive actions and proposed legislation that will stimulate economic growth immediately. Executive actions with immediate impact include a reduction in excessive personal income tax withholding and acceleration of previously appropriated Federal spending. Reducing the burden of unnecessary regulation and prudent measures to reduce the credit crunch will improve the environment for growth. Proposed legislation focuses on spurring job-creating investment. The proposed 15-percent investment tax allowance and simplified and liberalized treatment of depreciation under the alternative tax, as well as the reduction in the capital gains tax, will stimulate business investment. The reduction in the capital gains tax rate will quickly raise asset values, improving confidence and encouraging spending. A $5,000 tax credit and penalty-free withdrawal from individual retirement accounts for first-time homebuyers, along with other incentives, will increase housing construction and sales.

Bolstering the short-term agenda are proposals for the long term that invest in the Nation's future by increasing the productivity of people and business. Record Federal investment in research and development and infrastructure, and the extension of the research and development tax credit will help increase business productivity. Record Federal investment in Head Start, children, and education, as well as proposals that strengthen the war on drugs and improve the implementation of job training through Job Training 2000 will help increase labor productivity. The long-term growth agenda also includes continued efforts to expand international markets through multilateral, regional, and bilateral negotiations.

Some of the President's reform proposals are awaiting congressional action. Education reform through America 2000 will revolutionize education, strengthen accountability, and improve performance. Financial sector reform will strengthen the financial system, improve its ability to contribute to business growth, and sustain its international competitiveness. Civil justice reform will curb wasteful litigation and enhance productive activity. And the National Energy Strategy will increase energy security and conservation.

The President has repeatedly proposed reducing the tax rate on capital gains. This will encourage entrepreneurial activity, create new products, new methods of production, and new businesses. These, in turn, will generate new jobs. A capital gains differential will reduce the tax bias against equity financing and the overall cost of capital, thereby increasing investment and growth. Moreover, the Administration has supported a zero capital gains tax for areas designated as Enterprise Zones to spur investment and encourage entrepreneurial activity in inner cities and rural areas.

Innovation increases productivity growth and the standard of living. The Administration has advocated making the research and experimentation tax credit a permanent part of the tax code and has proposed large increases in both basic and applied research and development spending in the Federal budget.

There are also proposals to assist families. These policies include an increase in the tax exemption for each child, a new flexible individual retirement account, and deductibility of interest paid on student loans. Comprehensive health reform will increase the affordability and security of health insurance at a cost that is economically sustainable. The incentives for first-time homebuyers, mentioned above, will encourage homeownership—one of the most important ingredients to family financial and social well-being. The homeownership and opportunities for people everywhere (HOPE) program helps low-income residents of public and assisted housing to manage and eventually own their own homes.

Fundamental banking reform is critical to ensuring efficient operation of credit markets. The recent bill passed by the Congress is at best only a start. Important provisions in the Administration's proposal that would remove many unnecessary and antiquated restrictions on the banking industry are missing from the legislation. These reforms are needed to rebuild the soundness of the banking industry and enable it to be internationally competitive.

The Administration believes a well-functioning legal and regulatory system should increase, not impede, economic activity. Through its Agenda for Civil Justice Reform in America, the Administration has proposed a comprehensive set of reforms to the civil justice system that will improve the efficiency of the legal system and reduce

unnecessary and costly litigation. This would free up resources and enhance productivity.

The Administration believes that investments in the Nation's human capital increase its productivity and living standards at home and increase its competitiveness abroad. The National Education Goals, America 2000 Excellence in Education Act, and Job Training 2000 all are directed at improving the quality of our most important resource—our people. The America 2000 Excellence in Education Act focuses on setting world-class educational standards, measuring performance against those standards, and increasing the educational choices available to American families so as to generate the competition that will improve performance and accountability of schools. The Administration's Job Training 2000 system is designed to train millions of workers in the skills needed in the evolving labor market.

Moreover, the President has initiated a variety of measures to expand opportunities and improve the well-being of individuals and families. Although not often thought of as economic policy, expanded tax relief for child care, Head Start, Healthy Start, protecting the civil rights of all Americans, the strategy to eliminate substance abuse, and measures against violent crime all serve to improve U.S. productivity in the long term. Starting our children off on the right path, providing our children the finest education, and continuing to provide programs that ensure safety are sound economic policies.

The President's economic and domestic agenda also includes investing in America's future by improving the Nation's infrastructure, enhancing energy efficiency and security, and improving the quality of the environment and life. The Administration continues to promote an energy policy that relies on the flexibility of market forces to ensure that the Nation's resources are used most efficiently. Implementation of the Administration's National Energy Strategy would enhance competition in the generation of electric power and in the delivery of natural gas and would reduce vulnerability to oil disruptions abroad.

This Administration is committed to free and fair trade. Because trade enhances long-term growth, the Administration is following a multipronged effort to open markets, expand trade, and spur growth. The Administration is committed to achieving a successful conclusion of the Uruguay Round of multilateral trade negotiations, under the auspices of the General Agreement on Tariffs and Trade. These ambitious talks, which were initiated in 1986 involve 108 countries and cover topics ranging from the elimination or reduction of tariffs, to the strengthening of international rules for trade in textiles and agriculture, to the extension of rules to cover trade in services and intellectual property. A successful Uruguay Round would expand market opportunities globally for our exporters, increase jobs, and provide lasting gains for both the United States and world. The Administration also has important proposals to expand trade in this hemisphere—notably the Enterprise for the Americas Initiative and the historic North American free-trade area—and is continuing to achieve market access through bilateral negotiations.

Taken together, the President's proposals constitute a comprehensive agenda to stimulate short-term economic growth and support long-term productivity growth. These policies will expand opportunities for workers and families, increase living standards, and support the global competitiveness of the U.S. economy.

Table 1.—FORECAST COMPARISONS

	1992	1993
Percent change, 4th quarter to 4th quarter		
Real GDP (1987 dollars):		
Administration	2.2	3.0
Blue Chip	2.4	3.0
CBO	2.8	3.3
CPI-U:		
Administration	3.1	3.3
Blue Chip	3.5	3.8
CBO	3.4	3.6
Calendar year average, percent		
Civilian Unemployment Rate:		
Administration	6.9	6.5
Blue Chip	6.8	6.3
CBO	6.9	6.4

Table 1.—FORECAST COMPARISONS—Continued

	1992	1993
3-month Treasury bill rate:		
Administration	4.1	4.9
Blue Chip	4.2	5.0
CBO	4.4	5.1
10-year Treasury note rate:		
Administration	7.0	6.9
Blue Chip	7.3	7.7
CBO	7.1	7.1

Note: Blue Chip values are survey averages from the January 1991 Blue Chip survey; 10-year Treasury note rates for Blue Chip are converted from the reported Aaa bond rates.

PREPARED STATEMENT OF NICHOLAS F. BRADY

Mr. Chairman and Members of the Committee: I am pleased to testify today on the economic proposals announced by the President in his State of the Union address and detailed in his Budget for FY 1993. The President's actions and proposals will accelerate economic recovery in the short term, stimulate the nation's long-term economic growth and increase the competitiveness of American goods and services in the world economy.

The President's comprehensive program for growth includes initiatives beyond those we shall discuss here today, for example: record federal investment in research and development; in Head Start and in children generally; in education; crime and drug abuse; and in preventive health. The President's program for Job Training 2000 will improve the delivery and effectiveness of job training and vocational education and his proposal to combine law enforcement and social services is designed to reinvigorate impoverished and embattled communities.

When enacted by the Congress, the President's plan will expand opportunity and enhance the nation's standard of living. The President's tax proposals are specifically addressed to the fundamental economic concerns of American families.

As you well know, Mr. Chairman, many factors have coalesced to make the economic recovery sluggish: We experienced a mideast crisis and a war, during which oil prices rose to over $40 a barrel. We have had two and a half years of restrictive, high interest rates that only recently have abated. The nation's businesses and its families and government borrowed too much. And, unfortunately, improving the climate for increased jobs and investment has not been a congressional priority.

SOME ENCOURAGING SIGNS

Nevertheless, there are some encouraging signs.

American corporations and families have moved to pay down their debt burden. The spiral of rising prices has been halted so that American families need no longer fear that run-away inflation will rob them of their purchasing power. And American businesses do not have to worry that rapid price increases will render American products noncompetitive in world markets.[1] American exports are strong, and business inventories lean.

Interest rates are now the lowest in twenty years. The decline in interest rates could, in 1992, save American families as much as $25 billion in interest costs on mortgages, and other household debt. Lower interest rates also should mean a savings of about $10 billion for American corporations, and federal, state, and local governments will save another $10 billion.

And all of this has occurred against the backdrop of the end of the Cold War, an economic stimulus that none of us can now calculate, but which will be, over time, of enormous proportions.

THE AMERICAN PEOPLE WANT ACTION

But positive signals are only the beginning. The American people remain concerned about the strength of their nation's economy. People who have worked in industries or companies that have contracted want to be confident that they can find new jobs and if necessary shift careers. Families who own no home want to be sure

[1] Graphs 1 and 2 show changes over time in consumer and producer prices, respectively.

that they will someday, and homeowners hope to see strength in the value of their house, their most valuable asset.

American families deserve to be confident about their children's future, the quality and safety of their children's schools, and their ability to afford the education necessary to raise their children and grandchildren's standard of living.

The public is entitled to assurance about the soundness of the financial institutions on which they have long depended for help and security. Witnessing 'the failure of a savings and loan or bank where you or your neighbors have saved and borrowed is extremely unsettling. The country worries that American banks, which for so long were dominant in the world, are now overshadowed by foreign banks. Small businesses and other investors have had difficulty obtaining loans they need to expand their businesses and create jobs. And the Congress so far has refused to modernize the legal framework governing banks that was designed decades ago for a totally different economic era.

The American people deserve to be certain of our ability to compete in the new global economy. They demand that we maintain our advantage of superior technology and our capacity for stunning innovation.

ECONOMIC GROWTH IS THE ENGINE OF PROGRESS

Mr. Chairman, there is only one response that we, the Congress and the President working together, can make to fulfill the hopes of the American people. We should embrace policies that foster economic growth. We should move at once to enact into law the President's proposals that will accelerate economic recovery. We must demonstrate an unwavering commitment to creating an environment for sustained growth over the long term.

Over time gains in family income depend upon improved national productivity. Only sustained economic growth can improve the incomes of wage-earning men and women; only sustained economic growth will provide the resources to feed and house the poor and guarantee health care to all Americans. And only sustained economic growth—not higher tax rates—will increase the resources of federal, state and local governments.

There should be no misunderstanding about this important point. A one percent decrease in real GDP growth in 1992 alone could decrease federal government receipts by nearly $80 billion and increase the federal deficit by more than $100 billion during the period FY 1992–1997. A one percent lower annual real GDP growth rate during each of the years from 1992 to 1997 would decrease the federal government's receipts by more than $260 billion and increase the deficit by nearly $350 billion during that period. The productive power of economic growth as a contributor to government revenues is not controversial.

If the collapse of communism and the disintegration of the Soviet Union this past year have taught us anything at all, it is that government policies that concentrate on managing how limited resources are distributed among the people are a poor substitute for concentrating on ensuring economic growth.

THE PRESIDENT'S ECONOMIC GROWTH AGENDA

The President's economic growth agenda will accelerate economic recovery and job-creating investments, create opportunities for home ownership, foster a real estate recovery, and help families build for the future. The economic growth agenda set forth by the President is about jobs.

The plan calls for a new investment tax allowance, which would produce nearly $11 billion of tax savings in calendar 1992 for businesses that acquire new equipment, thereby increasing their cash flow and lowering their cost of capital. The President also recommends permanent adjustments to simplify and liberalize the alternative minimum tax to remove tax impediments for modernizing business plant and equipment. Both of these measures will provide manufacturers strong incentives to create new jobs.

Jobs and global competitiveness also demand that businesses carry on vigorous research and development. The President's plan would make permanent the credit for research and development and extend the rules for allocating R&D expenses to foreign and domestic income. Although, as the largest economy in the world, the United States continues to be the largest investor in R&D activities, the rate of growth of nondefense R&D has recently been much higher in West Germany and Japan, as Graph 3 demonstrates.

The President has increased funding for basic research by 29 percent since 1989 and continues to recommend record levels of federal funding for R&D. Each year since taking office, the President has proposed making the R&D tax credit permanent. This is the year for Congress to act.

The President also urges Congress to cut the capital gains tax rate, which will raise American living standards by unlocking job-creating investments, boosting productivity, and raising the value of productive assets. The President has proposed cutting the capital gains tax to 15.4 percent for taxpayers now subject to a 28 percent capital gains tax rate and to 8.25 percent for taxpayers now subject to a 15 percent capital gains tax rate.

Reducing the capital gains tax will be particularly helpful to America's new companies and small businesses in attracting start-up capital. Small businesses and start-up companies traditionally rely on equity capital—they cannot float bonds, issue commercial paper or compete with big corporate rivals for bank loans. These firms continue to be the source of new jobs; businesses with 20 or fewer employees generate over two-thirds of all net new private-sector jobs.

Lowering the capital gains tax to create jobs and make America more productive is a bipartisan objective. At least 220 Democratic Members of Congress—more than two thirds—have sponsored or cosponsored legislation to reduce the capital gains tax.

The argument really is about what kind of capital gains tax to have. The President's proposal is broad in scope. It would reduce the burden of overtaxation of inflationary gains for all Americans. It would benefit the large number of middle-income people who realize capital gains and would unlock capital for more productive uses. A targeted capital gains tax cut could not serve each of these important purposes.

The President's economic growth plan also recognizes the importance of a healthy real estate sector in our economy and the critical need to ensure that businesses have access to credit. Real estate and construction represent more than 15 percent of our GDP, and employ almost 10 million people. More than half of all household net worth is in real estate.

That is why—in addition to our ongoing efforts to keep interest rates down and increase credit availability—the President has asked for a $5,000 tax credit for first-time homebuyers, modification of passive loss rules for real estate developers, opportunities for greater pension fund investments in real estate, deductibility of losses on the sale of personal residences, and an extension of mortgage revenue bond authority.

The President also proposes tax incentives for enterprise zones to stimulate jobs and investment in disadvantaged rural and urban areas, and an extension of both the targeted jobs tax credit and the low-income housing tax credit.

President Bush's plan will both hasten economic recovery and help American families—with proposals that specifically address their most pressing concerns. These include an increase in the personal exemption for families with children; and a new flexible IRA that will allow families to begin saving, regardless of purpose, without any income-tax burden.

In combination with the other proposals I have mentioned, the President's $5,000 tax credit for first-time homebuyers will help middle-income families purchase their own homes and offer protection to current homeowners from declining property values.

In combination with the President's proposal to increase funding for Head Start by $600 million and the Administration's other education initiatives, the proposals to permit deduction of interest on qualifying student loans and penalty-free IRA withdrawals, will help families fulfill their educational goals.

The President's comprehensive health plan, which he presented last week, builds on the strengths of the existing market-based system. It will provide tax credits or deductions for the purchase of health insurance of up to $3,750 for poor and middle-class families. This will provide financial help for more than 90 million people.

These initiatives will provide stimulus in both the short and long term. They will make it possible for American families to buy homes, save for college, guard against major health expenses, and plan for retirement.

The President's plan is directed at the specific needs and aspirations of most Americans. For families attempting to buy a home, save for the future, finance educational loans, or purchase health insurance, the President's plan provides substantial tax savings.

FAIRNESS

Issues of American justice arise in many contexts. But there can be no doubt that among them is the requirement that the burdens and benefits of government must be fairly distributed. The President's plan meets this test of fairness.

The current distribution of taxes and transfers is essentially fair, despite widespread claims to the contrary. As Graph 4 demonstrates, the net effect of federal

tax and transfer programs is highly progressive. In 1990, households in the top 20 percent paid an average of over $22,000 to the federal government, households in the lowest twenty percent received an average of almost $8,800 from the federal government.

But I do not wish to dwell on statistics. Statistics can be used to show almost anything. For example, tax distribution tables depict only the burden of payroll taxes and leave out entirely the payment of social security and federal health insurance benefits. These social insurance programs which are highly progressive should be included in any fairness charts, but they are not. Comparisons of the tax burden alone, without the benefits, present a very distorted picture. However, even if viewed by itself, the federal income tax is also progressive.

The President's plan for economic growth is fair. The full array of the President's tax proposals, including the President's health plan, would dramatically decrease taxes for low- and middle-income families and would only slightly reduce taxes for those with higher incomes.

THE NEED FOR FISCAL RESTRAINT

The President's program to accelerate the economy, provide jobs, and improve the climate for long-term growth is accomplished while maintaining the fiscal restraint of pay-as-you-go. We cannot achieve economic growth if federal spending is not controlled. Confident, stable financial markets live in the house of financial discipline, and interest rates and long term growth depend on adherence to this principle.

THERE IS NO SILVER BULLET

Creating an environment through this nation's tax, spending, and regulatory policies that invites and sustains long-term economic growth is no simple task. There is no silver bullet. However, we now have an opportunity to put some important building blocks in place.

The President in his State of the Union address requested congressional action by March 20 on seven proposals:

- The capital gains tax reduction;
- The investment tax allowance;
- The AMT enhancement and simplification;
- The easing of passive loss restrictions on real estate developers;
- The $5,000 credit for first-time homebuyers;
- The waiver of penalties on IRA withdrawals by first-time homebuyers; and
- The proposals to facilitate real estate investment by pension funds and others.

These proposals should be enacted immediately to accelerate economic recovery. The total cost of these proposals over the period FY 1992–1997 is just over $6.6 billion. The President's budget provides a variety of ways to cover this cost in a manner consistent with pay-as-you-go discipline. There is simply no reason why the President's economic growth proposals should not be financed through reductions in federal spending. The President would prefer prompt enactment of all of his program. But surely these few changes can be enacted now. It should be done promptly. And it must be paid for.

CONCLUSION

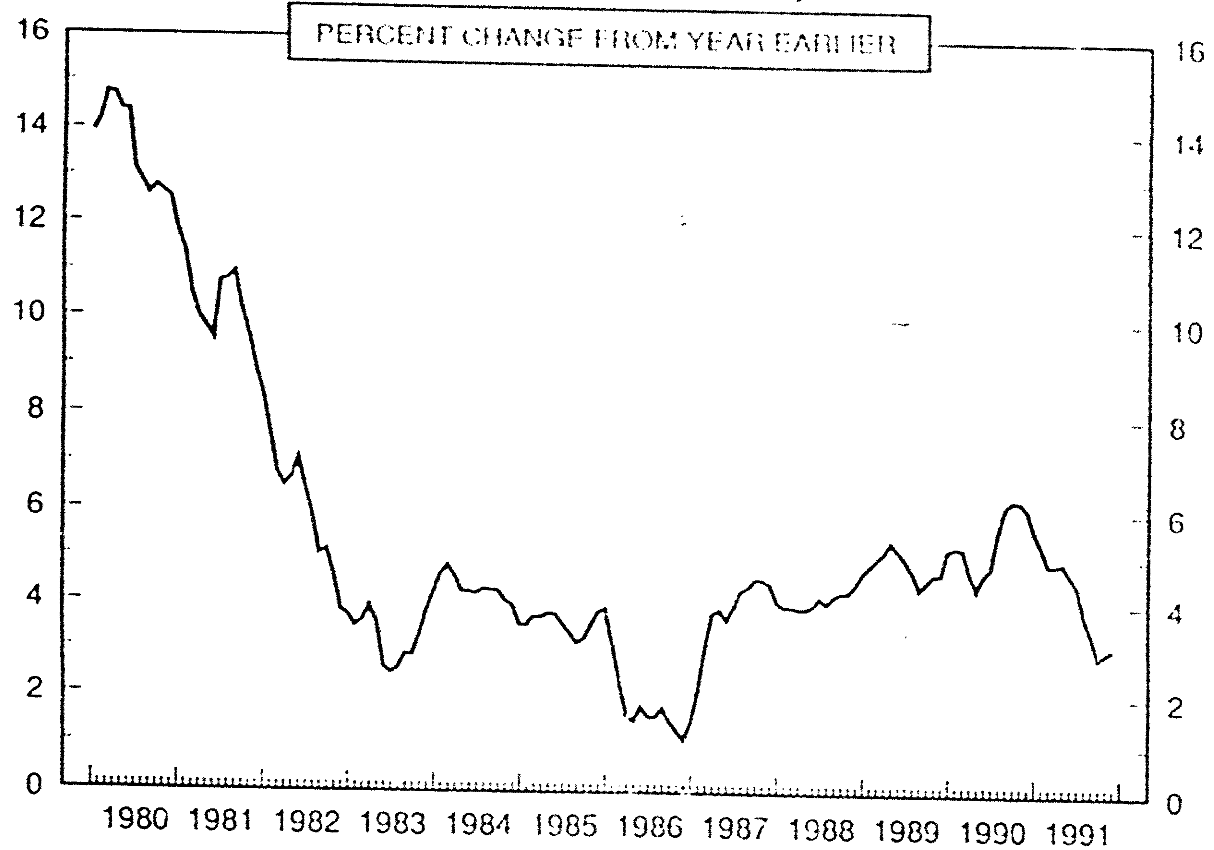
Today, this nation remains the world's preeminent economic force. The United States is the world's largest exporter of goods and services and the world's largest foreign investor.

No one should underestimate the energy and optimism of the American people, nor the resilience and fundamental strengths of the American economy. The government alone cannot make American products more competitive, but, in partnership, the President, the Congress, American businesses and workers can construct an environment to facilitate the nation's productive growth.

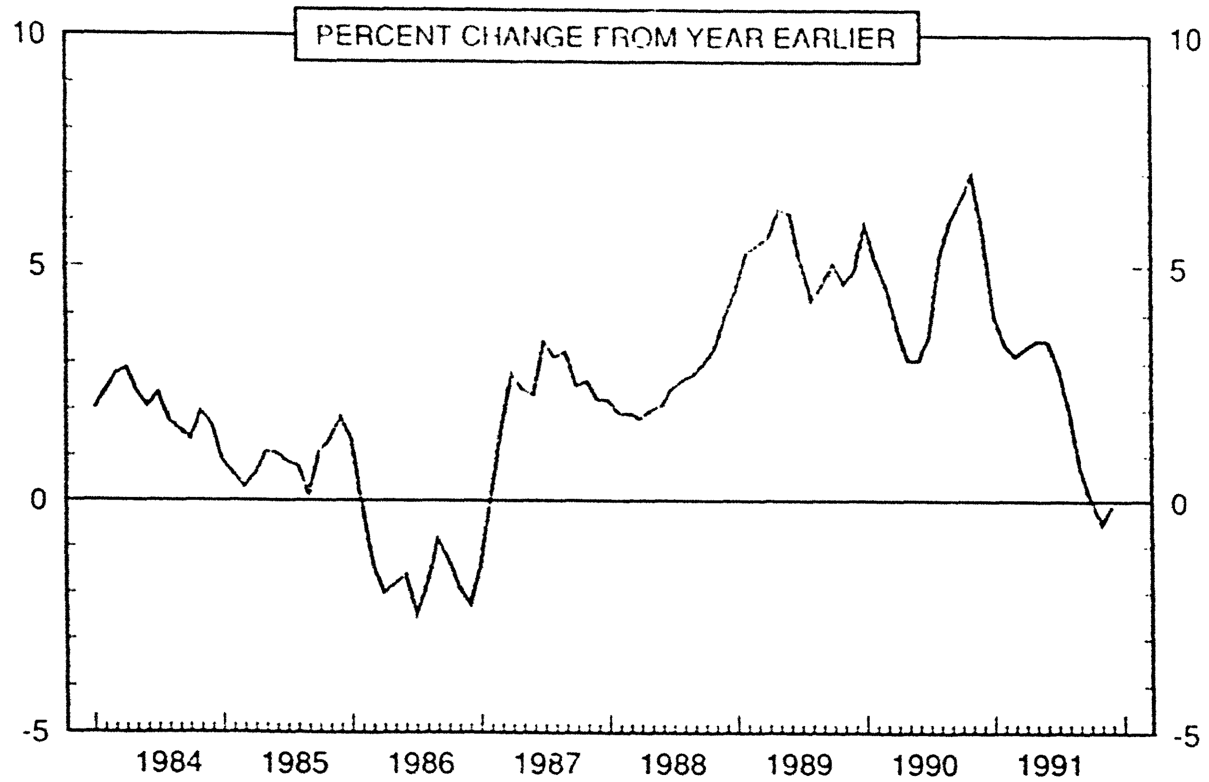
Attachment.

Graph 1

Consumer Price Index, All Items

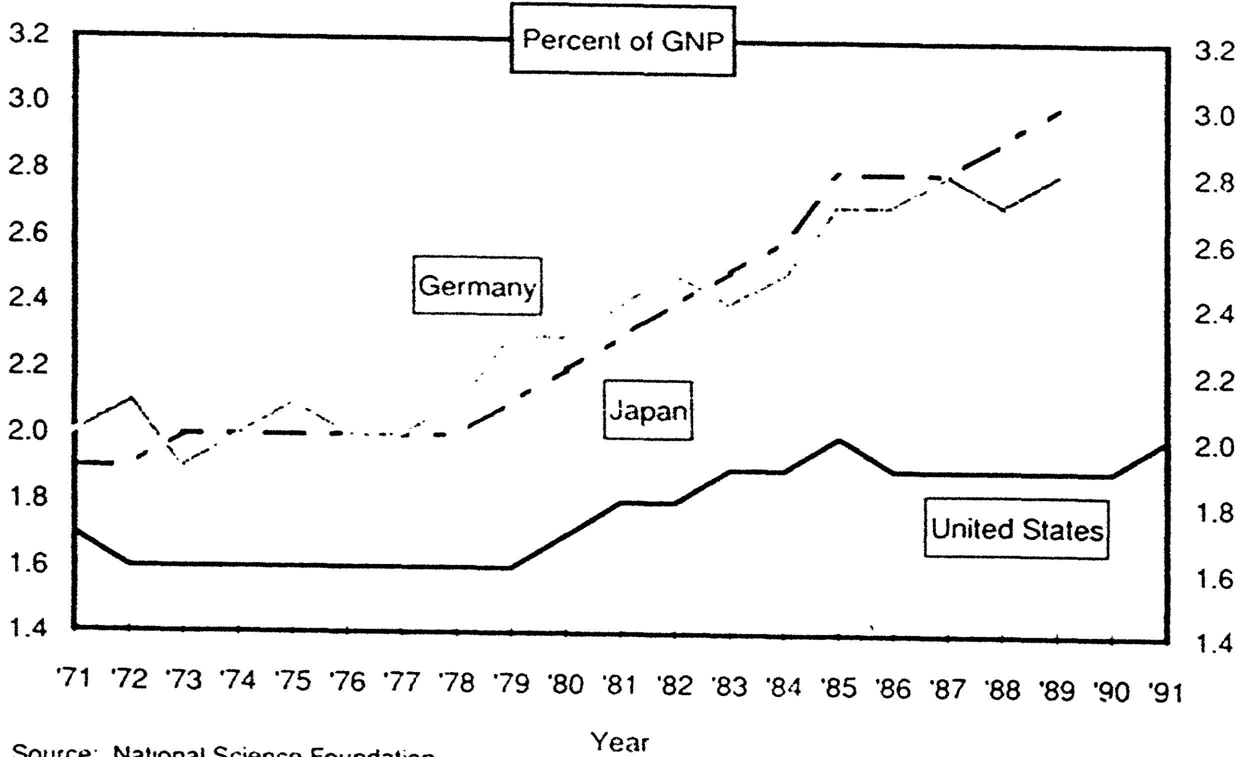


Graph 2
Producer Price Index for Finished Goods



Graph 3

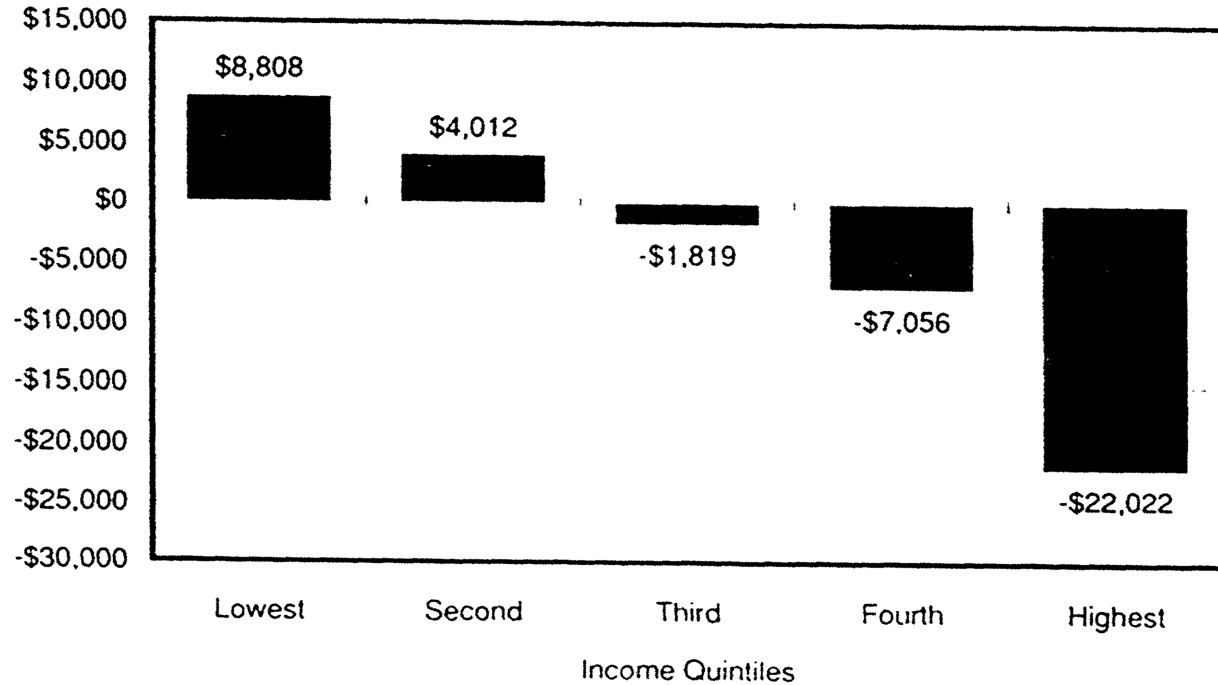
Non-Defense R&D Expenditures



Source: National Science Foundation
('90-'91 data not available for Japan, Germany)

Graph 4

Effects of Federal Tax and Transfers on Take-Home Income, 1990



Source: Bureau of the Census

PREPARED STATEMENT OF SENATOR JOHN H. CHAFEE

Mr. Chairman, I appreciate this opportunity for the Committee to examine the President's budget. I believe our top priority over the coming weeks must be to pass a tax package that encourages economic growth thereby providing more jobs for Americans. While, at the same time, striving not to increase the deficit.

Under President Bush's budget for 1993, the deficit is projected to be almost $352 billion; or $1,400 per man, woman, and child in this country. We cannot continue to ignore the fact that we are leaving a horrible legacy for our children. While the size of the annual deficit as a percent of our Gross Domestic Product has not risen, our total outstanding Federal Debt has continued to sky-rocket. In fact, total interest on the public debt will exceed $300 billion for the first time in 1993.

I remember when President Johnson was deeply concerned that the total Federal Budget he submitted to Congress broke the 100 billion dollar barrier. President Johnson and the Congress worked together to prevent the budget from reaching that level. And, now, less than 30 years later the interest costs, alone, in the Federal Budget will exceed three times that amount.

In my opinion, the most important step that Congress can take to help improve the long-term growth and competitiveness of the U.S. economy is to reduce the Federal budget deficit. While short-term interest rates have dropped dramatically over the last few months, long-term rates have lagged behind. These interest rates have remained artificially high because of the tremendous borrowing needs of the Federal government.

Now, let me turn to what I believe are the current deep concerns of the American people:

- retaining their jobs or finding new ones;
- maintaining the value of their homes; and
- keeping their health insurance and controlling rising health care costs.

I do not believe short-term tax credits or individual tax cuts will address these concerns.

If you ask any American if he or she would like to have an additional $500 exemption, the answer will of course be yes. The real question, however, should be: "Do you want to increase the Federal deficit by $5 billion (which your children will have to pay in the future), so that you can receive 29 cents per day per child in reduced taxes?" I know the answer in Rhode Island is "No." What they are looking for is actions which will produce more jobs.

FIRST, to maintain and create new jobs we must:

a. establish an investment tax credit that provides a real incentive for businesses to expand during this sluggish economy;
b. provide some type of relief for capital gains to reduce the cost of capital and encourage the flow of capital to new investments;
c. make several of the expiring tax provisions permanent: the R&D tax credit; the moratorium on the 861–8 allocation rules; the targeted jobs tax credit; and the exclusion for employee educational assistance; and
d. repeal the luxury tax on boats.

Everyone of these items will lead to increased economic growth and greater employment opportunities for all Americans.

SECOND, we need to restore the confidence of the American people in the real estate industry. To do this we must:

a. make both the mortgage revenue bond program and the low-income housing tax credit permanent;
b. allow penalty-free withdrawals from Individual Retirement Accounts for the purchase of a first-home; and
c. revise the passive loss rules as they apply to the real estate industry.

AND, THIRD, later this year we must deal with measures to provide greater access to health care. Certainly, one of them must be to equalize the tax treatment of health insurance for all Americans by making the cost of health insurance premiums tax deductible for those who purchase health insurance whether on their own or as a self-employed individual.

I look forward to working with you, Mr. Chairman, and with the Administration to develop a package that will include provisions to address the real concerns of Americans:

- retaining their jobs or finding new ones;
- maintaining the value of their homes; and access to health care.

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine. I am currently a Senior Economic Counselor to Data Resources-McGraw Hill, Inc., and a Fellow at the Economic Strategy Institute. I appreciate the opportunity to testify before the Senate Finance Committee on the current economic situation, the near and long-term outlook, the President's economic proposals, and on my own policy recommendations.

INTRODUCTION

In order to look ahead with some degree of confidence, it is necessary to examine the performance of the U.S. economy during the last several years, with particular reference to the recession that appears to be still in place. In particular, there have been several misconceptions regarding the recession that should be addressed. These include the following:

A. This recession is mild. This view has been expressed repeatedly by many economists and others, but in my view, it is dangerously misleading. Many measures show declines over the past eighteen months at least equal to the average of previous recessions, some even worse. Furthermore, some of the current statistics will eventually be revised downward. BLS estimates appear to understate the decline in payroll jobs, based on data being reported by state governments, for example. While the 1990-1991 recession is far from the worst, it nonetheless is a significant recession, with a lot of pain and suffering, that should not be passed off as a mild blip or temporary inconvenience.

B. This is an oil-shock recession. It should be obvious by now that that is not the case. In fact, it appears that the national recession may have begun one or two months prior to the Iraqi invasion of Kuwait; furthermore, many regions and industries were in fact already experiencing recessionary conditions well before the national recession began. And, overall economic growth averaged only a little more than 1% at an annual rate for the eighteen months prior to the beginning of the recession, indicating an extraordinarily high degree of vulnerability. The aftermath of the invasion clearly made the economy worse, thus making what might have been a milder recession more severe.

C. This is a Fed-caused recession. It has been fashionable to also blame the recession on the Federal Reserve. However, the Fed began to ease at least a year before the recession began, as indicated by a near 200 basis point decline in the federal funds rate from the spring of 1989 to early summer of 1990. While we can all debate whether they should have eased earlier and/or more sharply (as I believe), the recession nonetheless was not preceded by a sharp reduction in reserves, and an upward spike in short-term interest rates, as has frequently been the case in the past.

D. This recession is typical. Regardless of the cause, many economists view this as another in the long string of recessions that have occurred in the post-war period, with very similar characteristics. Many of them, therefore, expect a rather typical recovery. I believe, however, that this recession is in fact very different than virtually all of the other post-war recessions. As discussed below, it has been caused more

by structural, long-lasting factors than the relatively temporary factors that have been responsible for most previous downturns.

THIS RECESSION IS DIFFERENT

There are numerous differences between the 1990-1991 recession and the previous eight that have taken place in the post World War II period. The major ones are as follows:

1. The long transition between rapid growth and recession. As discussed earlier, economic growth had fallen sharply by early 1989, averaging only 1.2% from that time until the summer of 1990. This is unprecedented--every other post-war expansion moved into recession almost immediately, without the long period of stagnation or transition that occurred this time around. In my view, this suggests that an adjustment process was under way well before the recession began, reflecting numerous factors that did not play a major role in previous recession periods.

2. Behavior of labor markets. Unemployment always increases sharply in recessions, reflecting both the difficulty of new entrants into the labor force finding jobs, and losses of jobs among the previously employed. However, in virtually all previous recessions, most of the job losses were concentrated in manufacturing industries, primarily among production workers, and layoffs or indefinite furloughs accounted for a large fraction of those job losses. This time around, however, job losses have been spread across a large number of industries and occupations, and a larger fraction have been accounted for by terminations (i.e., jobs were eliminated) rather than temporary or indefinite layoffs. This is significant because it has created deep job insecurity across the United States, which may have significant implications for the recovery.

3. It has been caused by long-lasting structural factors. While cyclical forces have played a role, I believe that a large part of the recession and earlier slowdown reflects more longer-lasting, structural factors than those which have produced recessions in the past. This in part explains why the sluggishness has already lasted for three years. These factors include the following:

   (a). Both corporate and household debt (in relation to profits and incomes) exploded in the 1980's, and remain far higher than at previous cyclical peaks. In my view, high outstanding debt levels have been holding down spending on consumer durables and on new investment (especially since both real incomes and profits are being squeezed).

   (b). Rising credit quality problems in real estate and other loans, coupled with regulatory changes requiring higher capital, have tightened credit standards--thus, even for households and corporations not constrained by current debt levels, they are not having as easy access to credit as during the previous five or six years.

   (c). Despite the rising budget deficit in nominal terms, fiscal policy has become restrictive. The increases in the nominal deficit are primarily due to rising interest expense, weak tax receipts due to the sluggish economy, and the explosion in thrift bailout costs, none of which are now stimulative. Meanwhile, the deficit package adopted in 1990 will produce sizable fiscal drag on an ongoing basis.

   (d). Many state and local governments are in the process of cutting spending or raising taxes to ease budget problems as well--current imbalances are the highest in decades.

   (e). The enormous overbuilding of most types of real estate in many areas, coupled with weakening property prices, has caused a sharp decline in new construction.

   (f). Nominal and real long-term interest rates remain very high at a time when most high rate of return expenditures have already been made.

(g). Real incomes have been falling, reflecting wage restraint in many sectors of the economy, job loss, and higher taxes.

(h). U.S. competitiveness in world markets, based on productivity, quality, technological leadership, etc. continues to decline. The trade deficit has fallen somewhat in recent years, but this primarily reflects the weak state of demand and the sharp decline in the dollar in the second half of the 1980's, rather than any shift in fundamental competitiveness.

These factors are very different than the inventory overhangs, oil price shocks, or other factors which caused previous mild recessions or slowdowns. This recession has thus been more of a balance sheet, financial recession than an inventory, tight money, or inflation caused recession. In effect, we experienced an expansion in the 1980's built largely on cheap oil, large tax cuts, military and construction booms, leveraging the system, and the willingness of foreigners to invest heavily in the U.S.-these factors are all being reversed. At the same time, the factors which are critical for long-term growth, such as saving and investment rates, productivity growth, the quality of education, competitiveness in world markets, etc., have all deteriorated. And, of course, we have borrowed heavily from the future--we are now paying the price. Therefore, the recession should not be considered as an isolated event but rather as part of the sharp slowdown which began about three years ago.

CURRENT ECONOMIC SITUATION

Retail activity, auto sales, and housing did pick up somewhat in the spring of 1991, but at a relatively modest rate; furthermore, most other sectors of the economy remained stagnant or continued to decline. Thus, the pickup last spring was very slow and uneven. Nonetheless, many analysts believed that this was the start of a sustained recovery, but this optimism proved false for several reasons. First, many counted on the post-war rebound in consumer confidence to trigger a surge in spending--however, the real constraint on consumer spending has been weak income growth and high debt levels. Secondly, the optimists also counted on easing by the Fed to trigger stronger economic activity--however, in part because the Fed eased too slowly, and in part because of the high levels of debt, high vacancy rates, and the strained financial system, lower interest rates have had a very limited impact. The uptick in the economy was thus temporary, reflecting post-war euphoria and pent-up demand, and an early summer in the eastern half of the United States (which pulled some summer-related spending forward). The upward momentum ended by mid-summer when the economy began to flatten out--in the last two or three months, the momentum appears to have been slightly downward. Thus, it is now clear that the situation in the Far East aggravated the downturn, causing additional downward pressure when war was about to break out, and that that activity was made up in the late spring and early summer of 1991. Now that those temporary forces have faded out, the ongoing structural factors continue to hold back the economy.

It appears that the recession is still in place. Virtually all manufacturing companies continue to report flat, or declining, orders. Retailing did pick-up somewhat in January, but the year-over-year comparison exaggerates the gain. Auto sales remain at rock bottom levels. And labor markets are still extremely weak. The only area of improvement appears to be a modest upturn in housing activity, particularly for existing homes.

On a regional basis, there is no region currently experiencing any sizable rate of increase in economic activity. Some, in particular California and much of the Midwest, appear to be sliding even more sharply than they did earlier in the recession. Any economic recovery at this point is thus still a forecast--there is no convincing evidence that the economy is now on a rising trend.

There are three factors in particular that are most responsible for preventing a meaningful sustainable upturn at the present time. First, the private sector is in the midst of a trend toward deleveraging that began several years ago, at least partially reversing the enormous buildup of private debt during the 1980's. Many corporations and individuals are having increasing difficulty servicing the debt that had already been accumulated. Many have balance sheets that are lopsided with debt, increasing the risks in their businesses or personal lives. Furthermore, the decline in the value of

many assets, especially real estate, has aggravated these balance sheet problems. Finally, some of that debt was incurred by stretching out the maturity of loans (auto loans are a prime example)--this too has caused many people to experience a decline in the value of their assets over time at a much more rapid rate than they were able to pay down debt. This ongoing deleveraging is an obvious limiting factor on economic growth, especially in comparison to the 1980's when the increased willingness to borrow contributed as much as a half to one percent per year to the growth rate. It shows up particularly in reduced demand for debt sensitive products, like autos, other consumer durables, housing, capital goods, and inventories.

Secondly, a significant trend toward disinflation is occurring in the United States. This is most evident in declining property values, in extremely weak commodity prices, in slower growth in wage rates, and in the difficulty that most companies in most industries are having in raising prices (many have been forced to cut prices). This trend toward disinflation is the result of many factors, including widespread excess capacity, intense domestic and foreign competition, efforts to improve productivity, and buyers resistance. The latter is particularly apparent in the corporate sector, where the weakness in profits is forcing many companies to increasingly resist price increases from their suppliers, pushing the disinflation process throughout the system. Price restraint and weak volumes in most industries are combining to hold down revenues--many companies are reporting revenue declines for the first time in many decades. While economists focus extensively on real GNP and other such measures of economic activity, most companies run their businesses off revenues--the weakness in revenues, coupled with the absence of any meaningful recovery, is causing the most widespread cost-cutting in the corporate sector that has been experienced in many years. This is taking many forms, including additional efforts to cut inventories, cutbacks in capital spending, wage freezes, benefit cutbacks, and mostly, an extraordinarily high rate of layoffs. All of these are further restraining economic activity--the layoffs are doing so in two ways, by reducing household income, and by causing widespread anxiety regarding job security (which has caused consumer confidence to plummet again).

Thirdly, the income imbalance at state and local governments has also become a major constraint on the economy. In particular, disinflation and poor income growth are restraining state and local government tax receipts at a time when rising medical costs, higher wages for government employees, federally mandated program increases, etc. are causing expenditures to continue to rise. The result has been the largest fiscal imbalance at the state and local government level since the depression--this in turn is causing widespread expense reductions (including layoffs) and increasing taxes.

While these factors continue to pull down the economy, there are some favorable elements in the near-term outlook, perhaps more so than at any time since the recession began. First, inventories are so low in may industries that additional cuts are likely to be very limited. Secondly, while the deleveraging trend remains in place, continued Fed easing can help the economy by lowering the cost of debt servicing. In particular, the declines in long-term rates that have finally started to occur are not only reducing monthly payments on many variable rate loans, but are causing a wave of refinancing which will also reduce such payments on many fixed rate loans. Thirdly, real incomes will be further bolstered by the sizable decline in oil prices over the past several months. Finally, lower mortgage rates have already begun to strengthen the existing home market over the past month or so.

The outlook for the near-term depends upon whether the increase in purchasing power from lower mortgage payments and lower oil prices is enough to offset the declines in purchasing power caused by higher taxes and job losses, and in how much of such added purchasing power will be spent in view of the low level of confidence. My best guess is that we will begin to see a slow upturn in consumer spending, and in new housing, sometime in the next several months, which will ultimately lead to a gradual overall economic recovery beginning by late spring. Because the structural factors listed earlier will continue to hold down demand for the foreseeable future, the recovery is likely to be very slow and uneven. It will take a number of years for debt to be brought down to levels that it is no longer a constraint on new spending; for banking problems to be worked out so that normal credit

standards can re-emerge; for vacancy rates to move toward more normal levels, so that new commercial building can increase; and for many state and local governments to eliminate their fiscal imbalances.

The strength of the recovery will also be held back by the fact that, even with recent declines, long-term rates remain extraordinarily high, particularly in relation to current short-term rates. These high long-term rates primarily reflect the massive Federal budget deficit still in place, combined with our low saving rate and a reduced flow of foreign capital. The recovery will also be held back by a slowdown in export growth, reflecting the weakness in economic conditions in many European countries, in Japan, and in Canada.

Thus, after a flat first quarter and a small uptick in the second quarter, I would expect to see GNP growth in the 2.5% range during the second half of this year and into 1993.

I continue to believe, however, that there are major downward risks which could delay the recovery even further, or cause it to be even weaker when it does begin. First, as mentioned earlier, it is not clear whether the added disposable income that will result from lower mortgage rates and lower oil prices will be spent in view of the weak state of confidence and the high debt position of many consumers. This is also true in the corporate sector--with the trend toward cutting costs, lower debt servicing costs for many corporations will not necessarily translate into more capital spending or hiring. Second, announcements of additional job cutbacks over the next few months cannot be ruled out--if such were to occur, the adverse effect on incomes, coupled with the possibility of even weaker consumer confidence, may adversely affect spending. Third, the longer the economy remains stagnant, the more likely that capital spending plans will be scaled back--this could become a problem later this year. Fourth, it is possible that the improvement we're now getting in the housing market, and any gains that might occur elsewhere in the economy in the months ahead, could stall out later this year if these gains do not produce an increase in new jobs, and/or if they simply represent the fulfillment of some pent-up demand, or a brief response to recent declines in long-term interest rates.

LONG-TERM OUTLOOK

Thus, a sustained recovery at this point is by no means a sure bet. And without significant changes, long-term prospects remain very poor. The underlying weaknesses and deterioration of the economy were hidden during the 1980's by the long expansion which began at the end of 1982, and continued unbroken until very late in the decade, but have now come to the surface. As indicated earlier, that expansion was by no means the result of a supply-side miracle or other magical transformation of the economy, or of favorable fundamentals.

As a result, now that the driving forces of the 1980's expansion have faded out and in fact are being reversed, there is nothing to take their place. In effect, we not only didn't build for the future, but we mortgaged our future at a time when our competitiveness in world markets continued to deteriorate. It was thus inevitable that the U.S. economy would stagnate--a temporary surge in exports reflecting the sharp decline in the dollar, and the continued inflow of foreign capital, delayed the day of reckoning somewhat in the late 1980's, but now the day has arrived. It already has been a very long day, with the likelihood that it will be even far longer.

The warning signs are numerous. They include:

- The virtual elimination of U.S. advantages in productivity in a growing number of industries (we've actually fallen behind in many), due largely to productivity stagnation in this country.

- The shrinking technological leadership that once characterized the U.S. economy.

- Massive trade deficits, reflecting declining U.S. shares of worldwide production in a large number of industries, in response to these changes.

- The dismantling of many important companies and industries, with many others headed in that direction.
- Widening gaps between the United States and other countries in the quality of eduction.
- Stagnate real wages for the majority of Americans during the last fifteen years or more.
- A distribution of income which is becoming more unequal.
- A banking system which is in shambles.
- An increase in resources devoted to essentially non-productive uses.

Very clearly, we have been going in the wrong direction as a country, at a time when our economic performance is more influenced by global factors. But, despite the assertions of some economists who point to the recent pick-up in exports as an indication that we are becoming more competitive in world markets, quite the opposite is the case. Witness, for example, the fact that the 1991 trade deficit probably exceeded $70 billion despite relatively low oil prices, despite the severe consumer-led economic decline, and despite the 50% decline in the exchange rate for the dollar since the mid-1980's. And witness the fact that we continue to lose share in many manufacturing industries, especially in high-technology.

What is most disturbing is that it is difficult to expect productivity growth to accelerate, and our relative competitiveness to improve, in light of the following:

- Our net investment rate is half of Japan's, and far below that of other major competitors.
- Our national saving rate is at a record low level, despite the so-called supply-side savings incentives.
- Our business sector is highly leveraged, which is causing additional downward pressure on non-defense R and D (which has already fallen below the rates in Japan and Germany).
- Declining SAT scores and other measures show that the quality of education at the elementary and secondary school levels continues to deteriorate, falling further below our major competitors.
- Our infrastructure continues to decay, reflecting the neglect of the 1980's.
- No systemized effort is underway to improve job training and provide the needed skills for the 1990's.

It was fashionable in the 1980's to brand anyone who made these observations a doom and gloomer or a pessimist. But you can't grow an economy forever by building empty office buildings and Patriot missiles, and by doing leveraged buyouts and stock buy-backs. The lessons are clear: the factors that were largely responsible for the highly prosperous 50's, 60's, and early 70's, namely our enormous competitive advantages in world markets and our strong growth in productivity, no longer exist. And it should be obvious that the economic policies, and indifference and neglect, of the 1980's are not the solution--if anything, they made things worse.

PRODUCTIVITY-OUR MAJOR ECONOMIC PRIORITY

The ultimate goal of any effort to restore economic health is to raise living standards for the vast majority of the population, and in so doing, significantly improve prospects for the next generation. This can only be accomplished by achieving a much higher rate of productivity growth than the less than one percent average between 1973 and 1991.

An acceleration in productivity growth is also vital for a number of other reasons. First, it is clear that the major factor in the loss of international competitiveness of the United States has been an erosion of the productivity advantages that most U. S. industries previously enjoyed. This

has resulted not only in the loss of U.S. market share in an increasing number of global industries, and enormous trade deficits, but has created downward pressure on the number of high-paying manufacturing jobs, on average wages, and on the U.S. dollar, all of which have reduced real wages and living standards for many Americans. Secondly, the lack of significant productivity growth in non-tradable sectors has also prevented any meaningful improvement in living standards for workers in those industries--only if productivity picks up can this trend be changed. Finally, only a meaningful improvement in productivity growth can produce the necessary economic growth to enable us to address the serious social problems which exist in this country, including drug abuse, illiteracy, crime, social decay, etc.

It is important to note that what is required is not merely a one-time increase in productivity, such as has occurred in many companies as a result of staff cutbacks or closure of relatively inefficient plants. What is needed is an acceleration in the trend in productivity growth, or repetitive year-after-year gains, such as this county experienced in the first thirty years after World War II, and such as is now occurring in Japan and many other countries. And it must be economy-wide--improvements in productivity in some industries which take place primarily as a result of outsourcing and other measures which shift the problem elsewhere will not effectively solve most of our problems. Finally, it is also important that acceptable gains in productivity take place in a relatively fully employed economy--improvements in efficiency, or downsizing, which reduce employment in some industries is only acceptable in an environment where the demand for labor is rising sufficiently in other industries to keep the economy fully employed.

NATIONAL ECONOMIC STRATEGY

I strongly believe that a national economic plan to restore productivity growth, competitiveness, and improving living standards is absolutely essential; these will not materialize without such a plan. I believe that the national economic strategy must be consistent with the following basic principles:

1). As mentioned earlier, there has been a dramatic change in the global economy, and the United States position in that economy, during the last fifteen years. In particular, the United States no longer has the vast advantages in productivity, product quality, and technological innovation and implementation that it did in earlier years. These declining advantages have come at a time when world trade represents a larger share of the U.S. and world economies, so that declining competitiveness has a more adverse effect on economic performance now than it did in earlier periods.

Most significantly, these changes suggest that economic and trade considerations can no longer be secondary to political, national security, and other factors in setting policy in the United States. Thus, we can no longer "give away the store" by providing unlimited access to U.S. markets to other countries (who do not reciprocate) for State Department considerations, or to buy their support on other global issues, because we no longer have the competitive advantages to offset the differential in market access and other such factors. Similarly, we can no longer afford to spend six percent of our GNP to defend the free world when our major foreign competitors are spending only a fraction of that.

2). The guiding principle of domestic policies in the U.S. has been "what's good for the consumer is good for the economy". This, in addition to political factors, has underlined our trade policy--it also lies at the heart of our domestic anti-trust and tax policies. But the jobless, or those earning lower real wages, cannot maintain their standard of living no matter how favorable these policies are. The key to consumption is real wages and employment--I believe that our economic and other policies have to be shifted to better balance between consumption and production.

3). The national economic strategy must be multi-dimensional. Any simply-minded, narrowly focused solution, whether it be in macro economics (such as simply cutting marginal tax rates, or a capital gains tax cut), or in education, or any other policy area, should be rejected. I strongly believe that the decline of the United

States has been caused by a combination of factors, none of them devastating individually, but all of which have added up to the economic malaise which characterizes the U. S. economy at present. In my view, each of these areas must be addressed in order to turn the situation around: this includes effective macro policies that will increase our investment in productive assets; reversing the decline in the quality of education; stabilizing health care costs; preventing the continued disappearance of major industries, particularly those that have important linkages to others; restoring our leadership in technology; etc.

4). I strongly believe that the development of a national economic strategy, and to some extent its implementation, must be led by the Federal government. The Federal government has always had a major role in the U.S. economy, starting with the industrial revolution which resulted in U.S. economic leadership in the world for almost a century.

5). I believe that the focus of the national economic strategy should be as follows:

a). To significantly increase the amount of productivity-enhancing investment, so that the capital stock per employee, in both quality and quantity, will begin to approach our major foreign competitors;

b). To bring about a dramatic improvement in the skills of our work force, both by improving the quality of public education, and by increasing public and private job training;

c). To reverse the slide in United States technological superiority by beefing up basic research, and by speeding up the process by which new technological breakthroughs are translated into new products and into higher productivity.

6). Finally, the economic strategy should be based on the principle that what we make as a country is important. In particular, I strongly reject the notion that all goods and services are alike--that there is no difference between wood chips, potato chips, and semiconductor chips. Quite the opposite, it is extremely important to make certain that the United States has a major presence in those industries which represent the growth markets of the future, if in fact we want to experience strong economic growth; in those industries and products which have high multiplier impacts on the rest of the economy; in those industries and products which generate high value-added and thus produce high paying jobs; and in those industries and products which are leaders and drivers of new innovation, and without which the process of new technological development will be set back. Thus, we cannot accept another period of economic growth accounted for by the construction of empty office buildings, Patriot missiles, and the like, while more and more of our key industries are permitted to deteriorate.

This does not mean significantly greater economic management of the economy, or that the Federal government should consistently pick winners and losers. But, some industries are important for the well being of the country as a whole, so that if they are not permitted to develop, or if certain existing industries are permitted to go under, the entire economy will lose. Thus, permitting the development of some key strategic industries will be a win-win situation for the economy, rather than coming at the expense of other industries, because they will help create a higher employment, higher wage, more vibrant economy, thus increasing the demand for other goods and services as well.

<u>Role of the National Government</u>

The Federal government should have the following role in bringing about a better economic environment in the years ahead:

a). To set targets for various measures of economic performance. Included should be desired rates of saving, investment, and non-military R&D; average SAT scores; health care costs and

health care inflation; and productivity growth and overall economic growth, for the next ten years.

These goals should be monitored on a year-by-year basis, and if the trends are unfavorable, policy changes should be considered to increase the chance of achieving them. It is also important for these targets to be presented to the country at large, so that individuals, corporations, etc., have some understanding of where we want to be.

b). The Federal government should act as an example for the private sector by channeling as much of its own funds into productivity-enhancing expenditures as possible, by eliminating waste and inefficiency, etc.

c). It seems clear that one additional role of the Federal government will be to act as a catalyst in achieving our economic objectives. Thus, there will be times when the Federal government should bring various segments of the economy together in order to help them reach some agreement which might be in the national interest, or might facilitate some event or direction that might be helpful to the national economy.

d). It may be necessary for Federal funding to be increased for various activities if it is determined that reliance on the private sector alone will not be sufficient. For example, increased funding for pre-competitive research may be one area where the Federal government's role may need to increase in the years ahead. This implies a significant change in its own priorities.

e). Perhaps the most basic function of the Federal government is to create the proper business environment. This includes effective macro policies to increase saving and investment to bolster productivity and competitiveness, and taking prudent steps to reduce the budget deficit in order to cut the cost of capital to the private sector. Other policy measures, such as those which will encourage more private R&D, which might slow the growth in health care costs, etc., also need to be implemented.

f). Finally, micro policy changes will also be necessary, such as relaxing anti-trust laws to permit more industry consortiums providing assistance to key emerging or existing industries, more vigorous enforcement of existing trade laws, developing a trade policy more in tune with today's economic realities, etc.

It is my view that some significant changes in the basic structure of the economy and its major entities will also be necessary to facilitate a healthier economy in the years ahead. In particular, I believe that the current structure discourages patient capital--that is, investments with a long-term payoff--thus promoting a short-term orientation which limits our ability to compete in long lead-time industries. It is vital that we begin to make the long term investments which are needed to improve productivity and increase capacity, rather than the short-term, speculative, financial-type investments that were so prevalent in the 1980's. It is thus essential that we find ways to stretch out the investment horizon in the United States.

POLICY RECOMMENDATIONS

In my view, a proactive program to stimulate the economy is needed to insure a stronger sustainable recovery, and simultaneously to bolster our long-term growth prospects. The way to meet both of these needs is with an investment-oriented program that will dramatically increase our rate of investment in new, productive assets, thus helping raise our abysmal productivity growth and improve our competitiveness in world markets, while at the same time increasing short-term economic activity. I am therefore suggesting that the short-term stimulative program that we put in place be the first step in developing and implementing an economic plan to rebuild the U.S. economy on a long-term basis.

In my view, any stimulative package to address our short and long-term needs should adhere to the following guidelines: First, we should address our problems without widening our mind-boggling structural deficits (which will already be much higher than OMB is now estimating). These deficits are keeping long-term interest rates at least 2 percentage points higher than they otherwise would be, given the weak state of the economy and current levels of short term rates and inflation, and thus are another drag on economic growth. They are also increasing our dependence on foreign capital, squeezing out productive investment, and placing an unconscionable burden on future generations. Widening the deficit could cause long rates to go even higher, as recent nervousness in the bond market suggests. Deficit-neutrality would of course require creativity--it means that any actions that are put in place will have to produce a "big bang for the buck" by being targeted and focussed, and/or, are temporary. Second, we should accept the fact that most of the income growth and tax benefits which occurred during the 1980's accrued to people in the upper income groups. Any proposals to stimulate the economy must be fair by not making the tax structure even more regressive--in fact, some of the regressivity now in place should be reversed if possible.

We thus need an investment-led recovery, but weak profits, poor sales and the overleveraged condition of many companies are now, if anything, further depressing capital spending plans. However, many large corporations do have substantial cash and other assets that can be turned into new capital spending. The objective essentially is to encourage them to do so in order to prime the pump in the short term and improve productivity in the long term. My own view is that direct incentives to investment are a much more effective way to stimulate new investment than measures designed to increase private savings, especially since there is no reliable policy measure that affects private savings in the United States.

Some are suggesting that this can be accomplished by cutting the capital gains tax rate. However, capital gains tax changes by themselves simply do not impact fixed investment significantly. And its fixed investment that what's needed to help the economy off its back, and begin the process of boosting productivity and competitiveness. A straight reduction in capital gains tax rates will simply provide a windfall on investments already made (and thus raise the budget deficit in the long run), and perhaps generate some more trading on Wall Street. Studies by Professor Shoven at Stanford University, and by my colleague Roger Brinner, show that a reduction in the capital gains tax rate by itself has a relatively small impact on the cost of capital. The estimate that such a cut will generate more than a million jobs is thus ridiculously optimistic.

A better approach is to combine a restructuring of the capital gains tax with enactment of more effective investment incentives. In particular, the investment tax credit , which has had an excellent track record in stimulating new investment in the past, should be restored.

I suggest that a large credit (i.e. 20-25%) be implemented, but only on incremental investment, in productivity-enhancing equipment, over and above a base period. For any company, the base can be calculated as the average of investment during the last several years. Dramatically accelerated depreciation, or total expensing, on incremental investment would work just as well. All would not only provide a big incentive at the margin, but revenues would not be lost for investments that were previously planned. Thus, if they do not stimulate new investment, there would be virtually no revenue loss to the Treasury; if they do, the increase in economic activity will generate enough added revenues to basically pay for the credit or accelerated depreciation.

Changing capital gains taxes can help shift the pattern away from the short-term, financially-oriented, speculative type investments that characterized the 1980's to badly needed longer term investment. However, to accomplish even that, a much larger
difference between the rates on short-term and those on long term gains would be necessary. This can best be accomplished by enacting a sliding scale capital gains tax structure, incorporating an <u>increase</u> in the rate on short-term gains, with the rate declining the longer the asset is held (to perhaps near-zero for five years or longer). Furthermore, the relatively low long-term rate should apply only to investments in productive assets, and not to vacation homes, old buildings, etc.

The other arguments being used to support a simple cut in capital gains taxes are also flawed. For example, the assertion that cutting capital gains tax rates will help real estate is misleading at best. Commerical property prices and rents are falling because of the overbuilding of the 1980's, aggravated by declining service sector employment resulting from the current recession. And housing prices are declining in many areas because the speculative binge in the 1980's carried them too high, and because near record low consumer confidence, reflecting anxiety regarding job security, is short circuiting the normal moving-up process. In the long term, the only way to stabilize real estate values is to reverse the current weakness in the job market and in confidence.

I also suggest an increase in the top marginal tax rate, or implementing a third marginal tax rate (perhaps at about 35%) on relatively high incomes. While many advocate doing this on the grounds of restoring some fairness to the tax system, there is an even stronger reason to do so. In my view, such an increase would be pro-investment--it, coupled with a decline in the capital gains tax rate on long-term, productive investments, will encourage relatively high-income individuals to shift some of their safe investments into the riskier, long-term investments that the country needs. In addition, it would encourage more employees to enter the world of entrepreneurship. Both effects will come about because the changes suggested above will produce a large difference between the tax rate on long-term capital gains and that on short-term income (and short-term capital gains)--it is this difference, rather than just the level of the capital gains tax rate, that is important for venture capital, business start-ups, and other risky long-term investments. While a higher marginal rate might reduce new savings (this in fact is debatable, because if personal savings do fall, it will at least partly be offset by a reduced Federal deficit), the key is to make more effective use of the savings already in place. The current low marginal tax rate and the relatively high capital gains tax rate discourage risk-taking and long-term investing. As a further inducement, the low rate on long-term capital gains should be available only on new investments, further encouraging those now holding securities to shift to new investments, since they would not be eligible for the lower rate unless they do so. This would also have the advantage of unlocking a lot of existing investments, thus creating a short-term tax windfall.

I believe the country cannot afford a large broad-based income tax cut at the present time, especially if it is on a permanent basis. Even a short-term tax cut would probably do little good in that a relatively large fraction is likely to be saved. And, many of the proposals regarding expansion of IRA's would neither increase savings nor spending, and would probably widen the budget deficit.

To help improve the investment climate, some stimulus for consumer spending should be provided, however, as long as it does not widen the deficit, and is not offset by other restrictive measures. This can be accomplished by adjusting the Social Security wage ceiling and tax rate in a revenue neutral manner. Such a change would reduce taxes for a large majority of American families (and those which need it the most), would make the tax structure less regressive, and would provide a modest amount of stimulus by shifting income to those who would spend more of it. I also suggest that we further extend and widen unemployment benefits, and other safety net programs that were cutback during the 1980's, not only as a humane measure, but because the marginal propensity to spend out of these benefits is relatively high. Finally, I suggest enacting a refundable income tax credit on purchases of autos, other durable goods, and other discretionary items, for 1992 only. The size of the credit can be made to vary with income. It could also vary with domestic content in order to provide maximum stimulus for the U.S. economy. This is likely to be more effective than a straight income tax cut in stimulating spending in the short-term because, at the margin, it will make it more attractive to spend, because temporary tax cuts are usually saved, and because it will pull some spending forward. If in fact it does not result in any increase in spending over and above what would have happened anyway, it would be like an ordinary income tax cut that's saved--if it does result in more spending, it will help stimulate the economy.

The country also desperately needs more public investment. A much-needed rebuilding and upgrading of our infrastructure is essential if productivity growth is to be accelerated. This can be financed without enlarging the deficit by privatizing a modest amount of government-owned

energy facilities, such as the Tennessee Valley Authority and the Bonneville Power Authority. And over time, we should commit to using any additional cuts in defense spending to fund more public investment.

Because the decline in real estate values is having a depressing effect on the economy, any measures that would stem that decline, and allow banks to resume lending, but without encouraging more new building, would be desirable. I thus support the partial restoration of changes in the passive tax rules that were rescinded in 1986, but only for those involved in the management of real estate properties (and not for investors who use real estate write-offs to offset other income). In addition, an extension of the period over which banks can realize real estate losses, or reserve against them, might be helpful by enabling them to recognize such losses without curtailing other lending.

In order to carry out this program, and to pay for it, some changes will be needed in the current budget law. First, measures that are truly self-financing ought to be adopted without the required offsets (this would include the incremental ITC referred to earlier). Secondly, temporary budget-widening measures should also be permitted without offsets, which would otherwise dilute their stimulative impact. Thirdly, the firewalls from the 1990 budget law should also be eliminated, so that over the long-term, additional cuts in defense or other programs can be used to pay for some of the measures outlined above, especially more public investment.

Finally, I would encourage the Federal Reserve to continue to ease monetary policy. They probably will have to wait until the bond market begins to rally again, but additional easing could be helpful by bolstering real estate prices and confidence, both of which are added drags on the economy, and by further reducing the cost of servicing existing debt.

THE PRESIDENT'S ECONOMIC PROPOSALS

I believe the proposals above are far superior than the program outlined by the President in the State of the Union address, based on the early information on his proposals. In particular, I have the following concerns with the President's program:

1). The amount of near-term stimulus is very limited, especially since the increase in the per child exemption does not take effect until October 1. The shift in withholding will have very limited impact because most people deliberately over-withhold as a means of forced savings, and because at best, it will be considered a temporary tax cut to be offset by a tax increase (or lack of a refund) next year. The marginal propensity to spend from temporary tax cuts has been very small in the past. Furthermore, the tax credit for first time home buyers affects only a small portion of the marketplace. Housing is already far more affordable than it has been in many years, but uncertain job prospects are limiting the willingness to buy new homes. Finally, the credit might stimulate the purchases of existing homes, now owned in many cases by the elderly, who might then move to recently built condominiums that are now empty, resulting in little new building and economic activity.

2). While the tax credit for health care costs might help some people (the degree to which it will help will depend upon whether it's refundable), it does absolutely nothing to address the big issue of health care costs.

3). The President's proposals to permit penalty-free withdrawals from IRA's for various purposes will also be of limited value because many of the people who are considering buying their first home, or need to use their savings to cover medical costs, don't have IRA's to begin with. Furthermore, these new IRA's would likely cause a reduction in savings in the long-term by essentially permitting tax free deductions to cover various expenses, while at the same time increasing the deficit as people shift away from other non-taxable forms of savings.

4). The President's investment allowance in my judgement will provide a minimal incentive for new investment. This is so because it simply shifts some depreciation forward, while not reducing the total depreciation over the life of an asset, or the price of the asset. It thus reduces the cost of the capital only marginally. Furthermore, it will permit this acceleration in depreciation even for investments that would have been made in any case, resulting in some short-term revenue loss from those investments.

5). What is especially troubling is that the budget predicts deficits of $200 billion plus for the entire period, with a high likelihood of even larger deficits later in the decade once the military cutbacks are over, once social security surpluses are drawn down, and once the gimmicks which will hold down near-term deficits start working in the other direction. And this doesn't even factor in the cost of the President's health care proposals, the mythical savings, and the optimistic assumptions and gimmicks that are holding down their deficit estimates. In my view, acceptance of these deficits is unconscionable--they will continue to erode the vitality of the U.S. economy and further limit our long-term growth, exactly the opposite of what is needed.

6). My biggest concern is that the program does virtually nothing to improve our long-term productivity and competitiveness. I view the investment incentives as inadequate, especially since the cut in the capital gains tax rate that is the centerpiece of the Administration's program, as discussed earlier, will have only a small impact on investment and economic growth at best. And infrastructure and job training are hardly addressed at all.

7). Despite the high deficits, and despite the absence of any significant measures that will improve productivity and U.S. competitiveness, the Administration's budget asserts that the President's program will increase average economic growth by about 1/2 percent per year for the next six years (including 1992). I find absolutely no evidence whatsoever that any of the Administrations proposals will add anything to long-term economic growth--the sum total of these proposals, by substantially increasing long-term budget deficits, is more likely to reduce long-term economic growth.

PREPARED STATEMENT OF ROBERT CIZIK

My name is Robert Cizik. I am Chairman, President and CEO of Cooper Industries, Inc., a diversified manufacturing firm headquartered in Houston, Texas. I also am presently serving as Vice Chairman of the National Association of Manufacturers. On behalf of NAM's more than 12,000 member companies and subsidiaries, I am pleased to be here to present the Association's views on the tax proposals outlined in the Administration's recent budget message, as well as on a number of other proposals being considered by this Committee.

The first observation I want to make is that the size of the federal deficit constrains the use of typical fiscal policy tools--tax cuts and spending increases--to stimulate economic recovery. As a practical matter, the deficit situation tends to rule out both large increases in spending and large tax cuts.

Thus, while it seems clear that changed circumstances justify some revision of the 1990 budget agreement, NAM believes that, as the President has recommended, such changes should occur in the context of continued fiscal discipline. Accordingly, we recommend that any such changes be guided by these principles:

-- Any spending increases directed at short-term job creation should also have a long-term growth aspect. Two examples of this would be accelerated infrastructure spending and increased outlays for research and development (R&D).

-- Tax changes, overall, should be tilted in favor of investment rather than consumption and should not be illusory, e.g., they should not be offset by tax increases on the same class of taxpayers and should be available against both regular and alternative minimum tax liabilities. Tax reductions should be matched to the extent possible by offsetting spending reductions, not neutralized by offsetting tax increases.

-- Any overall increases in annual deficit levels should be modest and, when possible, offset by decreases in subsequent years--as should occur if spending already planned is advanced to an earlier year.

Revisions of the 1990 budget agreement within the foregoing limits would in our view have a more beneficial impact on the economy for both the short and long term than literal adherence to the terms of the agreement as it is presently structured.

Turning now to the specific subject of tax law changes, I want first to make a number of observations and suggestions on various elements of the President's proposed economic growth package.

Business Investment Incentives

President Bush outlined several proposals to stimulate capital investment in his State of the Union address. One of those proposals included changes to the Alternative Minimum Tax (AMT) which is having a negative impact on investment in many basic industries such as airlines, chemicals, steel, paper, motor vehicles and energy.

The Administration's proposal would eliminate the Adjusted Current Earnings (ACE) depreciation adjustment for property placed in service after February 1, 1992. While this approach is a major step forward conceptually and therefore deserves strong support, it should be recognized that it will not significantly reduce the cost of capital for many AMT-paying firms until sometime later in the decade.

This is because the AMT is by design intended to recapture depreciation benefits from property placed in service in prior years. Thus, in most cases a firm's current year capital spending has little impact on its current year AMT liability. The vast majority of the depreciation recapture under the ACE calculations is a result of prior year capital spending.

The President's proposal would be more effective if the ACE depreciation adjustment were entirely eliminated for property placed in service since the ACE adjustment went into effect. This would help to immediately reduce the cost of capital for--and spur new investment by, AMT taxpayers, which now represent the majority of basic industries.

The second objective of the Administration's AMT proposal is to simplify the calculations and recordkeeping associated with the AMT. Again, because the proposal is effective only for property placed in service after February 1, 1992, the complications of current law will continue until all pre-1992 property now subject to the ACE adjustment has been fully depreciated, which can be as much as 10 or more additional years for some basic manufacturing equipment. In other words, meaningful simplification wouldn't occur for many AMT taxpayers until after the end of the decade. Here again, the problem would easily be solved by dropping the ACE depreciation adjustment for all property placed in service since ACE became effective.

NAM believes the fundamental premise of the AMT--that for the sake of appearances corporations should pay some tax every year whether they have profits or not--is fundamentally flawed and ignores the realities of business cycles. It is not a practical problem for most taxpayers during periods of strong economic growth and high corporate profits, when most taxpayers pay the regular tax. During recessions, however, when profits

are low or nonexistent, many corporations find themselves writing checks to the Treasury even though they're not making any money. These payments, which essentially are a prepayment of future regular tax liability, would be much better used for job creation and factory modernization.

For this reason, we urge the Finance Committee consider carefully the AMT relief provision proposed by Senator Boren in S. 2159, which would provide for more effective utilization of AMT credit carryforwards. Senator Boren has correctly recognized that this recession has been prolonged by reductions and delays in capital spending projects due to increased AMT liabilities associated with past investment spending. Speeding up a taxpayer's ability to use credits for AMT paid in prior years will help alleviate this problem.

The second capital investment incentive proposed by the Administration is the temporary 15% Investment Tax Allowance (ITA). While we think the ITA is somewhat helpful, we are also constrained to note that its incentive effects are likely to be rather weak due to a number of fairly obvious design limitations: [1] its extremely limited 11-month duration and [2] the fact that it reflects only a timing difference. On the other hand, it has the great virtues of simplicity and broad applicability.

It is especially gratifying that the Administration has avoided both the massive complexity and inherent unfairness of an incentive designed to apply only to so-called "incremental" investment. NAM suggests two modifications to the proposed ITA:

-- Make it permanent rather than temporary so that it can contribute to sustained long-term growth and productivity increases. If this is not possible, the period of availability should be increased by at least another year, through December 31, 1993, provided property acquired by this date is placed in service by July 1994. Otherwise, we are quite concerned that the ITA's limited "window" of availability will fail to stimulate increased orders of advanced custom-designed manufacturing equipment which cannot be installed before the proposed cutoff date of July 1993.

-- Eliminate basis adjustment, so that the ITA provides a meaningful incentive in lieu of the modest stimulus offered by limiting its effect to solely a timing difference.

As a possible alternative to the ITA, NAM recommends that this Committee consider reinstatement of a permanent Investment Tax Credit (ITC) that is available against both the regular tax and the AMT. History has shown the ITC, implemented without any incremental feature, to be the most powerful and efficient of all investment incentives. Under dynamic revenue estimating techniques, the associated revenue loss is probably quite moderate. We believe the ITC generates greater revenue feedback than any other tax reduction showing the same amount of static revenue loss; in other words, the most "bang for the buck."

Even more important are the positive long-term effects. Our preliminary econometric analysis indicates that, with a permanent 10% ITC in effect, annual GDP after six years would be nearly $120 billion higher than under current law. At the end of the same period, employment would be 1.6 million jobs higher than under current law.

Capital Gains Tax Reduction

NAM supports the capital gains tax reduction proposed by the President. Here again, we believe the time is long overdue to rectify one of the major policy errors contained in the Tax Reform Act of 1986. Lowering the current excessive rate of tax on capital gains would have these major positive effects:

-- It would restore badly-needed incentive for entrepreneurial risk-taking, making more venture capital available.

-- It would "free up" large amounts of capital currently "locked in" old investments, capital that could then be reinvested in new, dynamic ventures.

-- It would provide at least a rough measure of relief for the fact that many so-called capital gains on paper are in fact capital losses due to inflation.

NAM urges that the President's capital gains reduction plan be enacted without any offsetting tax increases, such as marginal rate increases for upper-bracket taxpayers. The net effect of a zero-sum tax change is, as a practical matter, also pretty close to zero. Moreover, the unproductive distributional argument which has surrounded this issue for the past several years ignores the fact that the increased economic activity resulting from a capital gains tax cut benefits all Americans, not just those realizing the gains.

Simplification

It is widely acknowledged that the nation's tax laws are much too complicated, especially as they apply to business taxpayers. This excessive complexity often unjustifiably increases tax liability and almost invariably adds unnecessary compliance costs, impairing the ability of many U.S. firms to compete in the global marketplace against foreign-based producers not similarly burdened. It is thus appropriate to include simplification measures, particularly in the foreign income area, in a economic growth package. In this regard, we particularly recommend adoption of a number of proposals contained in S. 936, the Foreign Tax Simplification Act, introduced by Senator Baucus of this Committee. The approaches taken in that bill could achieve considerable simplification with only moderate revenue effects.

R&D Tax Changes

NAM supports the Administration's proposal to make the current temporary R&D tax credit permanent. Technological innovation is one of U.S. industry's most important weapons in the battle to stay competitive in an increasingly global economy. Making this credit permanent will greatly enhance its effectiveness as an incentive for increased R&D activity by U.S. manufacturers. NAM also supports the Administration's proposal to extend, for an additional 18 months, the current compromise rules on allocation of domestic R&D expenses under Section 861 of the Internal Revenue Code. We urge, however, that this extension be made permanent, since the same rationale for making the R&D credit permanent applies to this situation as well.

Luxury Tax Repeal

NAM supports the Administration's proposal to repeal the so-called "luxury tax" on boats and airplanes. We urge, however, that this unwise and counterproductive tax also be repealed on automobiles and other items to which it presently applies. NAM has long opposed the selective imposition of taxes on narrowly-defined product lines since they are inherently unfair and distort economic activity. While under certain circumstances NAM would support increasing the relative burden of taxation borne by consumption--provided the increased revenues are used to reduce the deficit and lower other taxes, and not for additional spending-- we believe any such shift should cover the broadest possible base of consumption.

Health Care Reform

Since we are still engaged in analyzing the details of the President's health care reform proposals, we will not make any overall comment on it at this time. We do want, however, to make known NAM's vigorous agreement with the Administration's decision not to include two items in its strategy for dealing with the health care issue: [1] employer mandates, and

[2] increases in the tax burdens of either employers or employees. NAM would strongly oppose any proposed health care reform package which relied on employer mandates and/or tax increases on either employers or employees. Similarly, we believe it is critically important to avoid financing expanded access to health care by further shifting costs from the public sector to the private sector.

General Observations

While we are quite supportive of the President's overall economic growth package--which contains many significant nontax features such as reduction of unnecessary regulatory burdens and important initiatives in education and workforce training--we are frankly concerned that the plan's tax components are somewhat out of balance. Permanent consumer or "middle class" tax cuts measured in the tens of billions annually will have but transitory effects on growth at huge revenue cost. We believe a more productive--and much less costly--approach to improving long-term growth and competitiveness would be to offer permanent investment incentives and only temporary consumer tax cuts. We are firmly convinced that capital investment incentives, especially a permanent, non-incremental ITC available against both regular tax and AMT liability, will generate more economic growth and more jobs, dollar for dollar, than an equivalent amount of consumption-oriented individual tax cuts.

Other Legislation

I would like to comment briefly on the approaches taken in other bills introduced last year for consideration by this Committee, applying the principles outlined at the beginning of my testimony. Some of these bills, such as S. 995 introduced by Senator Gore, would provide large "middle class" tax cuts paid for entirely by tax increases on upper-income taxpayers. This is an extremely poor idea. The problem in this country is hardly that we underconsume and overinvest. It is, rather, exactly the reverse. To shower some classes of taxpayers with tax cuts that will largely be spent on consumption, and to withdraw offsetting sums from those taxpayers having the wherewithal to save and invest meaningful amounts, is bad tax policy and even worse economic policy.

A more useful approach is that taken in S. 1921, introduced by this Committee's distinguished chairman, Senator Bentsen. That bill wisely employs the technique of pairing tax cuts with offsetting spending reductions rather than attempting to raise taxes elsewhere. The improved Individual Retirement Account (IRA) incentives offered in S. 1921 are particularly welcome and would generate a much-needed increase in long-term retirement savings. The bill's additional tax credits for dependent children, however, are subject to the general comments we have made herein on the relative efficacy of consumption-oriented tax cuts versus investment-oriented tax cuts.

Finally, I want to express NAM's support for the President's goal of prompt enactment of an economic growth package. We urge the Committee to make every effort to enact a responsible and balanced economic growth package as soon as realistically possible.

This concludes NAM's prepared testimony on this matter. I would be pleased to address any specific questions any member of the Committee may have.

PREPARED STATEMENT OF RICHARD G. DARMAN

2. DIRECTOR'S INTRODUCTION (AND OVERVIEW TABLES)

HOPES, FEARS, AND FALLIBLE FORECASTS

A year ago, the Budget was published in a context of major uncertainty. Iraq's invasion of Kuwait had destabilized the Middle East. That caused obvious problems for the American economy, which was already experiencing sluggish growth. The allied military counter-offensive had begun. But the outcome was not yet clear. Understandably, the mood was somber.

In the intervening year, the international situation improved dramatically. Kuwait was liberated. A proud and grateful nation welcomed its returning troops with near-euphoric celebration. Comprehensive Mideast peace talks commenced. Imperial Communism and the Soviet Union were disbanded. And clearly, market-oriented democracy has been on the rise.

Yet, here at home, the euphoria of summer has been displaced by another winter's gloom. The domestic economy has not recovered in the manner that had been widely forecast. The economy turned up, as predicted, in the middle of the year. When the *Wall Street Journal* published its mid-year survey, 39 of 40 private sector forecasters predicted positive real GNP growth—an average of 2.4 percent—for the second half of 1991. Thirty-eight of 40 predicted positive growth for the first half of 1992. But the recovery faltered. Economists scurried to reestimate. The sputtering economy seemed to support the cautionary note in last year's Introduction: "macroeconomics is a highly fallible 'science'; macroeconomists are often closer to each other than to reality."

By several conventional statistical measures, the economy is not as weak as in some previous recessions. But confidence is remarkably low. And although the unemployment rate is not as high as in some earlier periods, its level is unacceptable.

Many current problems are different from those associated with traditional business cycles. In general, there has not been an excessive inventory build-up. Rather, it is the accumulation of public and private debt that has been viewed generally as excessive. The financial sector has been under unusual stress. The real estate sector has been depressed. Much of the service sector (as well as white collar employment within the manufacturing sector) is in the process of restructuring. Such problems have been felt across a wider geographic and socio-economic range than was characteristic of earlier "blue collar" (or "rust belt") recessions. A more generalized sense of worry has developed among "middle class" workers and families.

For these reasons, and for all the conventional reasons, the current context requires a strong program and prompt action to get the economy moving again. But the character of the underlying problems makes clear: There must be more than just a short-term program. What is required is a *comprehensive* program to address not only the short-term, but also the long.

The President has advanced such a comprehensive program--to renew confidence, and to secure American growth in a competitive global economy. This Budget reflects that program.

THE PRESIDENT'S COMPREHENSIVE AGENDA FOR ECONOMIC GROWTH

In his *State of the Union Address*, the President has highlighted his agenda for growth.

Because unemployment remains high, the President has proposed a further extension of Unemployment Insurance Extended Benefits. But such benefits are obviously not a satisfactory substitute for a program to restore, expand, and secure jobs.

The President's agenda for job-creating growth is comprised of both short-term measures to get the economy moving and longer-term measures to secure American growth for the future.

The short-term agenda for growth includes the following:

(1) ***Executive Actions:*** **to strengthen economic activity in areas where the executive branch can proceed without depending upon Congressional action,**

- a *reduction of excessive personal income tax withholding* by an average of $346 per year (joint return) for those taxpayers who wish to have this burden reduced;
- continued *acceleration* of previously appropriated federal spending;
- prudent execution of measures to reduce the *"credit crunch"*;
- reinvigorated action to reduce the burden of *regulation*; and
- management of *monetary policy* (through the Federal Reserve) on a basis that yields both lower interest rates and low inflation;

(2) ***New Investment Incentives:*** **to stimulate job-creating investment (see Chapter 22),**

- a *capital gains* incentive that reduces the tax on long-term gains to 15.4 percent (also important for the long term);
- a new *15% Investment Tax Allowance;*
- simplified and liberalized treatment of depreciation under the *Alternative Minimum Tax;*

(3) ***New Real Estate Incentives:*** **to increase home sales and real estate values (see Chapter 22),**

- a new *$5,000 tax credit* for first-time home-buyers;
- a *modified "passive loss rule"* for active real estate investors;
- *penalty-free IRA withdrawal* for first-time home-buyers;
- extension of tax preferences for *mortgage revenue bonds* and *low-income housing;*
- allowance of deductions for losses on *personal residences*—
- all in addition to the favorable effects of a capital gains incentive.

This set of short-term initiatives unquestionably would help get the economy moving. But to strengthen growth for the intermediate and longer term, as well, a serious agenda must be more complex and comprehensive. The list of necessary initiatives is long, and its reach is broad. A narrower focus simply will not get the long-term job done.

The President's comprehensive agenda for growth involves both reform and restructuring. In addition to short-term measures, it includes such initiatives as the following:

(4) ***Investment in the Future:*** **to shift public expenditures toward investment in the future and to improve private productivity,**

- record investment in federal *research and development* ($76.6 billion) and in federal support of both basic research and applied civilian R&D (see Table 6–2 and Chapter 6)—along with permanent extension of the *R&D tax credit* (see Chapter 22);
- record investment in *Head Start* ($2.8 billion)—for the first time covering all participating eligible 4-year-olds;
- record investment in *children* (over $100 billion) and in *preventive* health (see Tables 5–3 and 5–1 and Chapter 5);
- record investment in Education generally, and in *Math and Science* Education (see Chapter 4);

- record investment in combatting *crime* and *drug abuse* (see Chapter 9);
- record investment in infrastructure (see Chapter 7);
- *"Job Training 2000"*, to improve the delivery and effectiveness of job training and vocational education programs (see Chapter 4);
- major expansion of *"Weed and Seed"* ($500 million—see Chapter 8) linking law enforcement and social services—and linking these, in turn, with:
- *Enterprise Zones*—to bring entrepreneurship and opportunity to areas of "hard core" distress (see Chapter 8):

(5) ***International Market Expansion:*** **to expand opportunities for American exports in a regime of free and fair trade,**

- *GATT* negotiations;
- negotiations to establish a *North American Free Trade Agreement;*
- the President's *Enterprise for the America's Initiative;* and
- continued *bilateral efforts* to open markets for U.S. exports.

(6) ***Pro-family Incentives:*** **to ease the financial burdens of raising a family and saving for the future (see Chapter 22),**

- a new *Flexible IRA*—with penalty-free withdrawal for medical and educational expenses (in addition to first-time purchase of a home), and with tax- free withdrawal after 7 years;
- tax deductibility of interest paid on *student loans;*
- an increase in the personal income tax exemption of *$500 per child* (i.e., $2,000 per year for a family with four children)—as well as:

(7) ***Health Reform:*** **to increase the affordability and security of health insurance for all, while making the high-quality American health system cost-effective and economically sustainable,**

- *The President's Plan for Comprehensive Health Reform* (outlined further below);

(8) ***Budget Discipline:*** **to bring the growth of the federal budget and deficit under control (and to reduce the drain on savings),**

- a *freeze* on federal domestic discretionary budget authority; and a cut in total discretionary budget authority;
- complete *elimination of 246 programs and over 4000 projects* whose funding is not sufficiently justified (see Chapter 16);
- a *freeze* on federal domestic government employment, and a cut of total federal personnel by nearly 4 percent (see Table 2–8).
- in response to changes in the external threat, an orderly and carefully-planned further reduction in defense spending of $50.4 billion by 1997—making the total real defense cut 29 percent since 1989.
- an *enforceable cap* on the growth of unfinanced "mandatory" spending (see below and Chapter 18);
- a cap on cumulative subsidies of *hidden liabilities* (see Chapter 18);
- extension and refinement of the *caps, accounting improvements,* and *pay-as-you-go discipline* of the Budget Enforcement Act (see Chapter 18);
- initiatives for Management Improvement (see Chapter 15);
- all in addition to the most important deficit-reduction measure: enactment of the rest of the President's agenda for growth.

Most of the elements of the President's growth agenda noted above are new. In addition, there are major reform proposals still before the Congress awaiting action. The fact that the Congress has not yet acted on these does not make them any less important for long-term growth. They are, indeed, essential.

Among the comprehensive reforms still awaiting Congressional action are those to reform education, modernize the financial services sector, increase productivity, and reduce energy vulnerability:

(9) *America 2000:* to revolutionize American education, strengthen accountability, and improve performance—through a nation-wide reform movement and such federal programmatic initiatives as New American Schools and Educational Choice (see Chapter 4);

(10) *Financial Service Sector Reform:* including deposit insurance reform, interstate banking, and provisions for integrating financial services (see Chapter 12);

(11) *Legal Reform:* including tort reform, product liability reform, malpractice reform, and civil justice reform; and

(12) *The President's National Energy Strategy:* which received heightened, if fleeting, interest after the Iraqi invasion; and which, like the other major areas of unfinished business, continues to await Congressional action. For convenient reference, this outline of the President's Agenda for Growth is presented as Chart 2-1.

CHART 2-1. THE PRESIDENT'S GROWTH AGENDA

Immediate Agenda:

(1) Executive Actions
- Withholding adjustment
- Regulatory relief
- Spending acceleration
- Monetary policy

(2) Investment Incentives
- Capital gains
- 15% Investment Tax Allowance
- Modified AMT

(3) Real Estate Incentives
- $5,000 tax credit (first home)
- Modified Passive Loss Rule
- Penalty-free IRA Withdrawal
- Mortgage revenue bonds
- Low-income housing credit
- Loss deduction for personal residences
- Capital gains

Intermediate and Long-Term Agenda:

(4) Investment in the Future
- R&D (record level)
- Infrastructure (record level)
- Head Start/Children (record level)
- Prevention (record level)
- Education (record level)
- Math & Science Initiative
- Anti-crime/drug abuse (record level)
- Job Training 2000
- Weed & Seed
- Enterprise Zones

(5) International Market Expansion
- GATT
- North American FTA
- Enterprise for the Americas
- Continued bilaterals

(6) Pro-family Incentives
- Flexible IRA
  —Penalty-free withdrawal for health/education/first home purchase
- Student loan interest deduction
- Personal exemption increase
- Health reform

(7) Comprehensive Health Reform
- The President's Plan
- Health Insurance Market Reform:
  —Pooling
  —Guaranteed issue/coverage
  —Health Insurance Networks
- Health Insurance Tax Credit/Deduction
- Cost-effectiveness/containment measures
- Coordinated care incentives
- Prevention

(8) Budget Discipline
- Orderly cut in Defense
- Domestic discretionary freeze
- Personnel freeze
- Program and project eliminations
- Mandatory cap and subsidy cap
- BEA extension
- Management initiatives

Unfinished Reform Agenda (still before the Congress):

(9) America 2000 (Education Reform)
- New American Schools
- Choice
- National Goals/America 2000 Communities

(10) Financial Sector Reform

(11) Legal Reform
- Tort reform
- Malpractice reform
- Civil justice reform

(12) National Energy Strategy

OF DEBT AND DISCIPLINE—RESTRAINING DEFICIT GROWTH

Almost all would agree with the proposition that economic growth should be increased. Most would also agree with a second proposition: that growth of the federal deficit should *not* be increased—indeed, that deficit growth should be restrained and then reversed.

Fortunately, these two propositions need not be in conflict. A responsible growth program can have a powerfully favorable effect on the deficit. And a responsible deficit reduction program can have a favorable effect on growth. The two popular propositions can complement and reenforce each other.

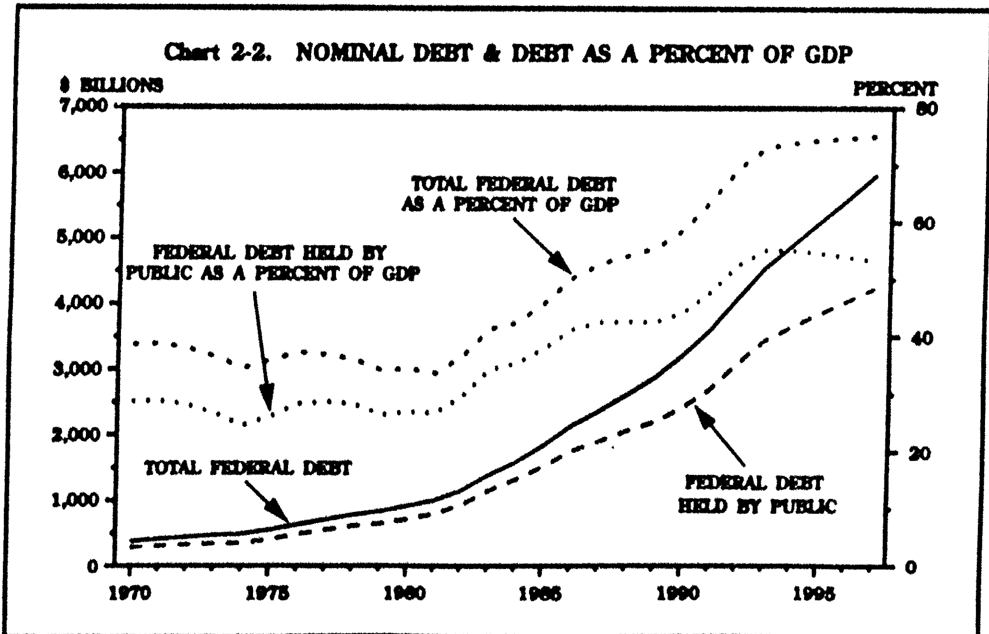
That might be thought of as good news. It might suggest that if the political system were to reflect these two propositions, it would not only do what is popular, but also what is responsible.

Unfortunately, however, the pleasant political complementarity of the two propositions depends on their being abstract. Regrettably, when it comes to particulars, only one of the propositions remains widely popular.

To cite the obvious as examples: A middle class tax cut is popular. But restraint on the growth of middle class entitlements is not. Investment in infrastructure is popular. Restraint on the growth of arguably "worthy" discretionary spending is not. Tax incentives to increase private savings are widely popular. The removal of broad-based tax preferences in order to increase public savings (i.e., to reduce deficits) is not.

Similarly, financing current expenditures with future payments (i.e., debt) is naturally much more popular than financing with current taxes or spending reduction. The taxpayers and consumers of the present are here and voting. Those of the future are not. (This lack of democratic representation, and the need to protect future rights, is the justification for a constitutional amendment requiring a balanced budget.)

The practical facts of political reality amount to a formula for rising deficits and rising debt. That, of course, is the observable pattern. (See Chart 2–2.)



While individuals and corporations have recently been strengthening their balance sheets, the Federal government has not. It is little wonder that, in observing the political dynamics of Washington, those in long-term financial markets have reflected concern about inadequate fiscal discipline.

The concern is legitimate.

With this concern in view, the President has proposed a budget that can fully accommodate his growth agenda—and that can be enacted in its entirety without abandoning the discipline of the Budget Enforcement Act. That is, the President's program does not require increasing any discretionary spending caps. It does not require transfers from one category of expenditure to another. And, if fully implemented, the President's program can meet the pay-as-you-go requirements without triggering a sequester. Indeed, it can exceed the pay-as-you-go requirements, and thereby contribute further to deficit reduction.

A summary of the pay-as-you-go accounting is at Table 2–1, with related detail at Tables 2–4 and 2–5. There will, as usual, be differences with respect to particular proposals reflected in these tables. But it is important to underline: *The President's strong and responsible agenda for growth can be fully enacted without abandoning the budget discipline of the Budget Enforcement Act.*

It is clear, however, that some in Congress do not wish to stay within the Budget Enforcement Act. Some wish to abandon its discipline entirely. Others wish to amend the Act in order to re-allocate defense savings for other purposes.

With these Congressional interests in view, the President's proposed defense savings are displayed at Table 2–2. The defense outlay savings are roughly sufficient to offset the President's proposed $500 per child increase in the personal exemption. Such an offset is not now possible under the Budget Enforcement Act; nor is it necessary under the President's program. But if the Congress were unwilling to accept fully the President's proposed pay-as-you-go financing of tax initiatives, the President would be prepared to consider modifying the Budget Enforcement Act to allow the projected defense outlay savings to offset the proposed increase in the personal exemption. This would be contingent, however, on the following:

- limitation of any defense savings to those that are consistent with national security interests;
- extension and refinement of the discipline of the current system of caps, mini-sequesters, and pay-as-you-go requirements;
- allocation of savings primarily to deficit-reduction and to families via tax reduction;
- corresponding downward adjustment of the total discretionary spending caps.

Even with adherence to the discipline of the Budget Enforcement Act, the near-term outlook for debt and deficits remains unattractive. (See Chart 2–3 and Table 2–3.)

There are three major reasons for this:

- *Carryover.* One major reason is the *carry-over effect of rising debt,* the associated *interest burden,* and the coverage of *deposit insurance.* Chart 2–3 shows graphically that interest and deposit insurance alone are almost equal to the entire federal deficit. Indeed, if interest and deposit insurance were not included, the federal deficit would quickly turn to surplus. This, of course, is not meant as a policy suggestion! It is simply to underline again a point that is increasingly evident: continuing to build up excessive debt and hidden liabilities has substantial costs that carry forward to the future. And at some point, the future is now.
- *Recession.* A second major reason for the near-term deficit problem is the recession and the continuing *weakness of the economy.* Chart 2–4 shows the extent to which enactment of the President's growth agenda would improve the deficit outlook relative to the likely pattern if Congress were to follow a conventional "business-as-usual" approach. (The deficit effect of alternative economic assumptions is displayed at Table 3–2, Chapter 3.)

Table 2–1. PAY-AS-YOU-GO PROPOSALS

(Savings, in billions of dollars)

	1992	1993	1994	1995	1996	1997	1992–97
(1) Carryover pay-go balance	1.1	1.1	0.5	1.0	1.4	–0.9	4.2
(2) Mandatory outlay proposals (except health reform and UI/EB)	0.5	3.4	5.3	5.9	9.9	9.8	34.9
(3) Revenue proposals (except personal exemption)	–5.2	0.7	3.1	0.9	0.9	-1.1	–0.7
(4) **Subtotal, before accruals and personal exemption**		**1.6***	**8.9**	**7.8**	**12.2**	**7.8**	**38.3**
(5) Deposit insurance reforms [1]	0.7	1.8	0.5	4.4	5.4	3.4	16.2
(6) PBGC reforms [1]	8.7	2.5	2.7	1.7	3.3	2.9	21 8
(7) **Subtotal, before personal exemption and Extended benefits/Unemployment Insurance**	**5.7**	**9.6**	**12.1**	**13.9**	**20.9**	**14.1**	**76.3**
(8) Unemployment Insurance/Extended Benefits	-2.2	-2.2	—	—.	—	—	–4.4
(9) Personal exemption	—	–4.4	–4.6	-4.7	-5.0	-5.2	-23.9
(10) **Total paygo scoring**	**3.5**	**3.0**	**7.5**	**9.1**	**15.9**	**8.9**	**48.0**

* Section 252(b) of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended by the Budget Enforcement Act, requires the Office of Management and Budget to take into account the impact of all direct spending and revenue legislation enacted as of the end-of-session sequestration report for both the current year (FY 1992) and the budget year (FY 1993).

[1] Assumes enactment of previously proposed reforms that reduce the competitive disadvantages of depository institutions and limit deposit insurance coverage, and reforms that revise minimum funding requirements, improve bankruptcy recoveries, and change the guarantee limits of the PBGC. In addition, assumes that the savings from these reforms are accounted for utilizing the long-established principles of accrual accounting. PBGC savings are estimated by applying reforms to only single-employer pension plans of publicly-traded firms.

Table 2–2. BUDGET IMPACT OF PROPOSED DEFENSE SAVINGS AND INCREASES IN THE PERSONAL EXEMPTION

(In billions of dollars)

	1992	1993	1994	1995	1996	1997	1992–97
Department of Defense (Discretionary):							
Summit Baseline (extended):							
Budget Authority	278.2	278.6	279.0	281.5	283.4	288.2	1,688.9
Outlays	283.9	279.7	274.0	275.3	279.4	284.8	1,677.1
Inflation Adjustments							
Budget Authority	0.0	-2.3	-2.4	-2.4	-2.7	-2.8	-12.5
Outlays	0.0	-1.0	-1.7	-2.0	-2.4	-2.6	-9.7
Adjusted Baseline							
Budget Authority	278.2	276.3	276.6	279.1	280.7	285.4	1,676.4
Outlays	283.9	278.7	272.3	273.3	277.0	282.2	1,667.4
Proposed Defense Levels							
Budget Authority	271.6	268.4	268.6	270.7	271.3	275.5	1,626.0
Outlays	283.3	273.5	268.2	268.7	271.7	274.5	1,639.9
Proposed Defense Savings							
Budget Authority	-6.6	-7.9	-8.0	-8.4	-9.4	-10.0	-50.4
Outlays	-0.6	-5.2	-4.1	-4.6	-5.2	-7.7	-27.4
Increase in the Personal Exemption by $500 per child (effective Oct. 1, 1992):							
Revenues	—	-4.4	-4.6	-4.7	-5.0	-5.2	-23.9

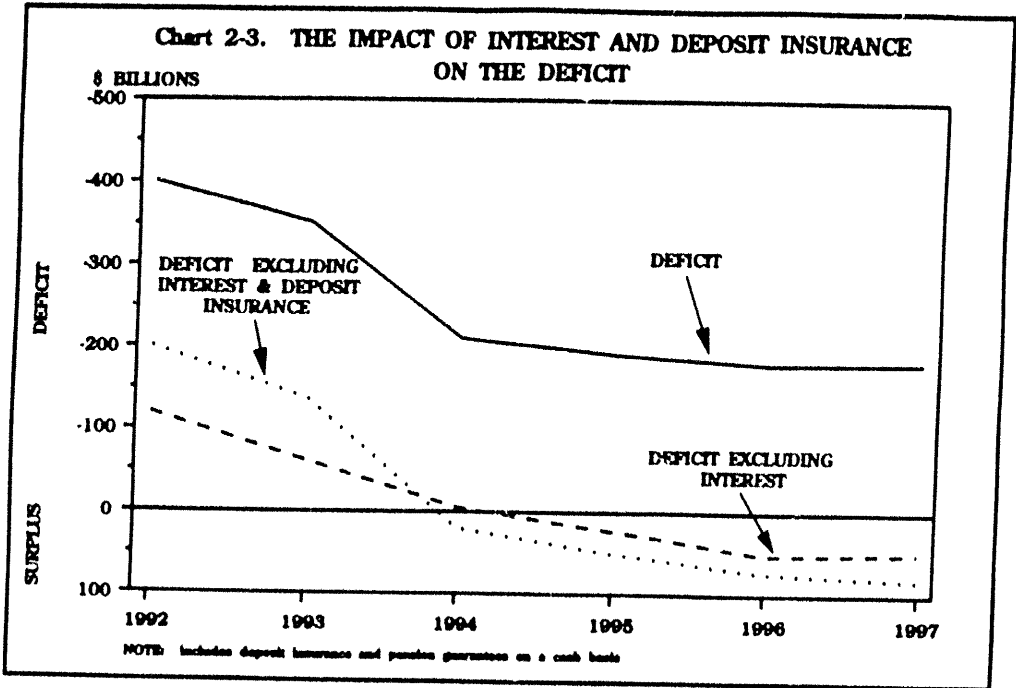


Chart 2-3. THE IMPACT OF INTEREST AND DEPOSIT INSURANCE ON THE DEFICIT

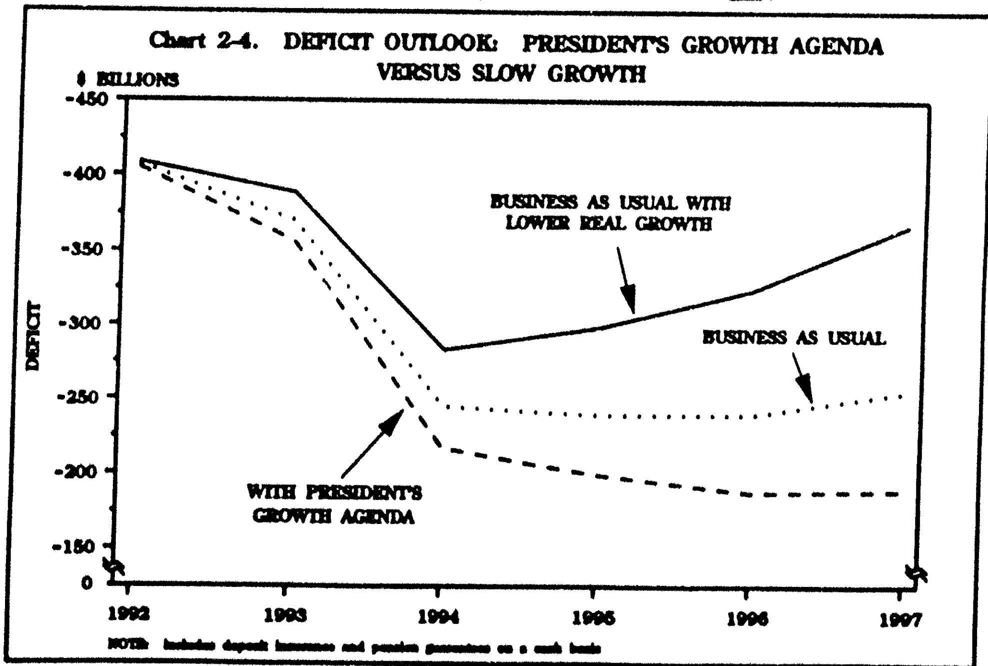


Chart 2-4. DEFICIT OUTLOOK: PRESIDENT'S GROWTH AGENDA VERSUS SLOW GROWTH

- ***Mandatory Program Growth.*** A third major reason for both the near-term and the long-term deficit problem is the continuing unrestrained *growth of so-called mandatory programs*. These are programs that do not come up for annual review or decision by either the Congress or the President. They are not "discretionary" in that they do not require annual appropriation; and they are not available for vote or veto. They just keep on going and growing automatically. Sometimes referred to as "uncontrollable," these programs are clearly out of control.

"Mandatory" programs for 1993 now amount to $766.8 billion in spending per year ($980.6 billion including interest). They are projected to grow at an average of 7.2 percent over the next five years (excluding deposit insurance). Mandatory programs now account for over half of the federal budget (64.4 percent including interest). By contrast, it is interesting to note that such programs amounted to only 23 percent of the budget in President Kennedy's day. (See Chart 2–5.)

Apart from returning to strong economic growth, slowing the growth of "mandatory" programs is the most important key to bringing the deficit under control. To illustrate this point, one might suppose that "mandatory" programs were allowed to grow only at the rate necessary to accommodate increases in the eligible population and increases in the CPI. (These are, perhaps, what many naturally assume to be the causes of mandatory program growth.) But if mandatory programs were to grow only for population and the CPI, there would be enormous *savings*. Indeed, the cumulative deficit savings (relative to business-as-usual) would amount to a *shocking total: almost $390 billion*!

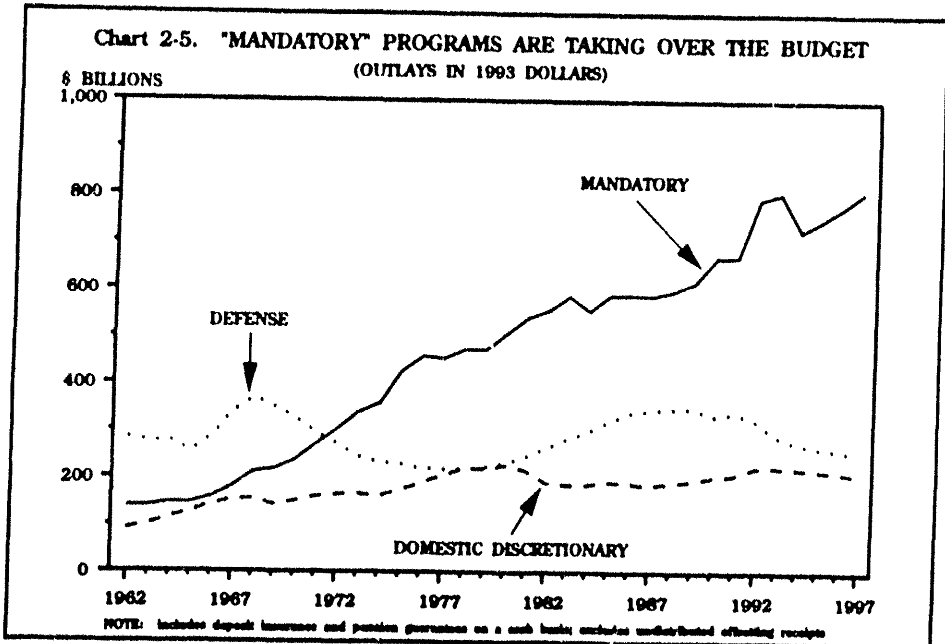


Chart 2-5. "MANDATORY" PROGRAMS ARE TAKING OVER THE BUDGET
(OUTLAYS IN 1993 DOLLARS)

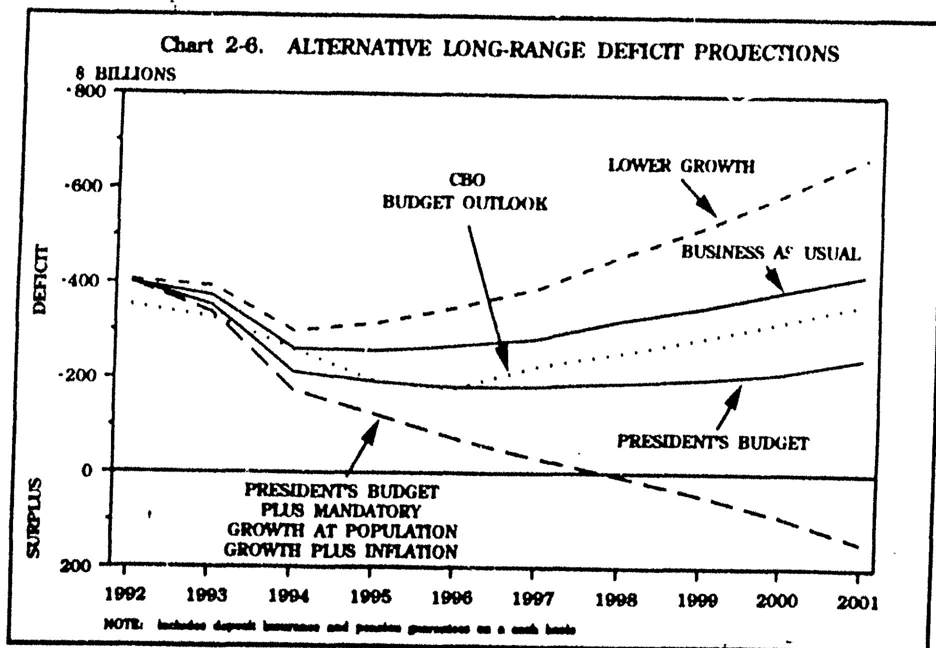
Chart 2–6 shows graphically how much this seemingly rather modest proposal could do for deficit reduction. There is no realistic or responsible set of additional discretionary program reductions that is remotely close in its deficit-reduction potential. Chart 2–6 also suggests what is inescapably the case: the budget can be brought into balance in the intermediate term only by enacting *both* a growth agenda *and* restraint on the growth of "mandatory" programs.

For this reason, the President's Budget goes beyond defense reductions and a domestic discretionary budget freeze. It also includes proposals to reduce the growth of mandatory spending by $68.4 billion by 1997. (See Table 2–4 for a summary of the proposed mandatory program changes.) This total does not include the very substantial additional savings that can and should be achieved with a serious approach to health reform (as discussed below).

In addition to specific proposed program changes, the Budget proposes to reduce the growth of hidden liabilities by capping cumulative total subsidies. (See Chapter 18.)

Further, the Budget proposes to remedy what is a fundamental flaw in the present system of budget discipline. The Administration supports an expanded and refined variation of the "entitlement cost cap" recently endorsed by the majority of the House Budget Committee. In order to give the Budget Committee's general concept focus and to move toward workable legislation, a more specific proposal is offered here:

- to cap "mandatory" program growth in aggregate;
- to set the cap at one growth rate prior to the enactment of comprehensive health reform, and at a lower growth rate following the enactment of comprehensive health reform;
- to set these growth rates at population-plus-CPI-plus an average of 2.5 percent and 1.6 percent, respectively;



- to require that any projected growth beyond the mandatory cap trigger the legislative reconciliation process to correct the excess spending growth; and
- as a fail-safe, to modify the pay-as-you-go system so that any uncorrected breach of the aggregate mandatory cap automatically triggers the sequester provisions for mandatory programs (while exempting Social Security from any such sequester).

If enacted, this addition would force legislative action on what is now "uncontrollable". It would slow the growth of the "mandatory" spending that is the largest part of the budgetary problem. This one procedural reform would go a long way toward remedying the most serious weakness in the discipline system of the current Budget Enforcement Act.

The existing Budget Enforcement Act system is really a combination of two systems. One is the old "Gramm-Rudman-Hollings" system, enacted in 1985. It was the principal disciplinary system for fiscal years 1986 through 1990. It returns to full force for application in 1994. But while that may be somewhat helpful, its earlier record does not offer great promise. The originally legislated Gramm-Rudman-Hollings deficit target for 1990 (its fifth year) was $36 billion. The actual result was $220 billion! It was this failure of the original Gramm-Rudman-Hollings system, in part, that necessitated the addition of a second system in 1990.

The second disciplinary system includes credit reform accounting, discretionary spending caps and associated mini-sequesters, and the pay-as-you-go system for new "mandatory" and revenue legislation. Each of these reforms has proved valuable and workable. All have been honored. But unfortunately, there is a vast area of spending they do not reach: *the entire inherited structure of automatic expenditure under pre-1990 law governing mandatory programs.*

This inherited structure is built into an explosively expanding spending "baseline." And although it amounts to more than half the budget, it is largely exempt from budgetary discipline. Hence: *the inescapable need for an enforceable cap on the growth of total mandatory spending.*

THE NEED FOR COMPREHENSIVE HEALTH REFORM

Individuals, families, businesses, and governments—all are increasingly strained to meet the growing burden of financing health (or more correctly, financing health care).

Within the vast "mandatory" program structure, health is increasingly dominant in its influence upon spending growth. It is the most rapidly growing. It is about to surpass Social Security in scale. And federal spending on health is rising sharply both as a percent of the federal budget and as a percent of GDP. (See Chart 2–7.)

What is true for the federal budget is also true for the nation as a whole. U.S. national health expenditures per capita have been rising dramatically in real terms. (See Chart 2–8.) U.S. per capita health expenditures have grown out of line with other developed countries. (See Chart 2–9.) Total U.S. public and private spending on health is literally on an *unsustainable path*—threatening to consume an impossible proportion of Gross Domestic Product. Even assuming a slowing of the trend, health expenditures will soon exceed 15 percent of GDP—up from slightly over 5 percent in President Kennedy's day. (See Chart 2–10.)

The fact that the current financing trends are unsustainable is sufficient to necessitate reform. But in addition, there is a strong equity argument for reform.

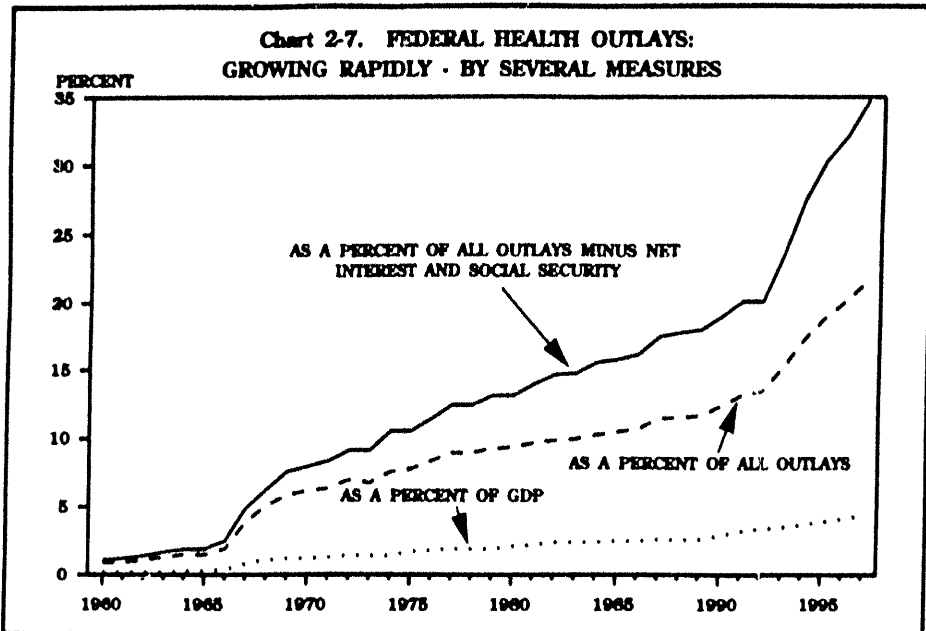


Chart 2-7. FEDERAL HEALTH OUTLAYS:
GROWING RAPIDLY - BY SEVERAL MEASURES
PERCENT
35
30
25
20
15
10
5
0
AS A PERCENT OF ALL OUTLAYS MINUS NET INTEREST AND SOCIAL SECURITY
AS A PERCENT OF ALL OUTLAYS
AS A PERCENT OF GDP
1960
1965
1970
1975
1980
1985
1990
1995

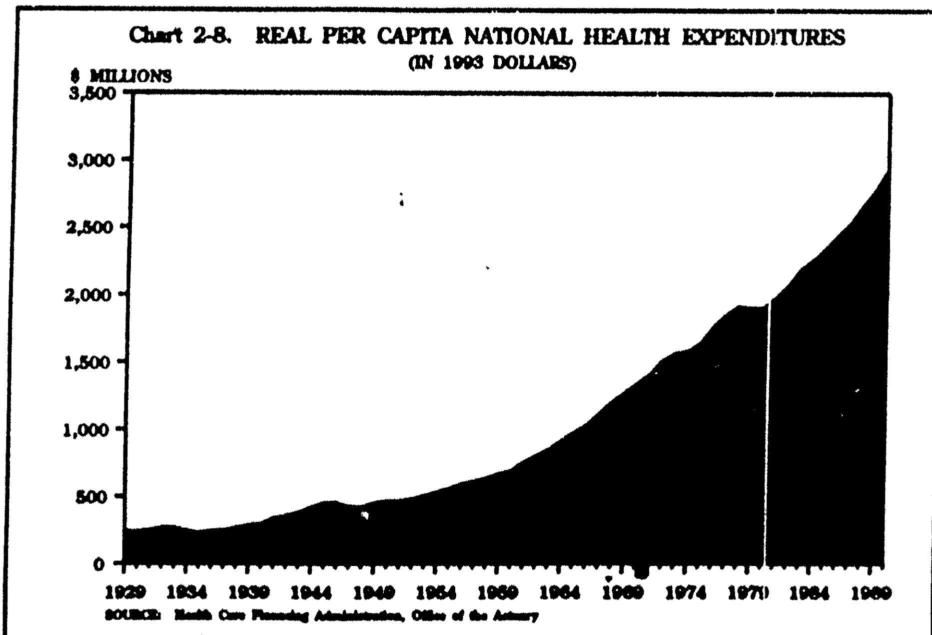


Chart 2-8. REAL PER CAPITA NATIONAL HEALTH EXPENDITURES
(IN 1993 DOLLARS)
$ MILLIONS
3,500
3,000
2,500
2,000
1,500
1,000
500
0
1929
1934
1939
1944
1949
1954
1959
1964
1969
1974
1979
1984
1989
SOURCE: Health Care Financing Administration, Office of the Actuary

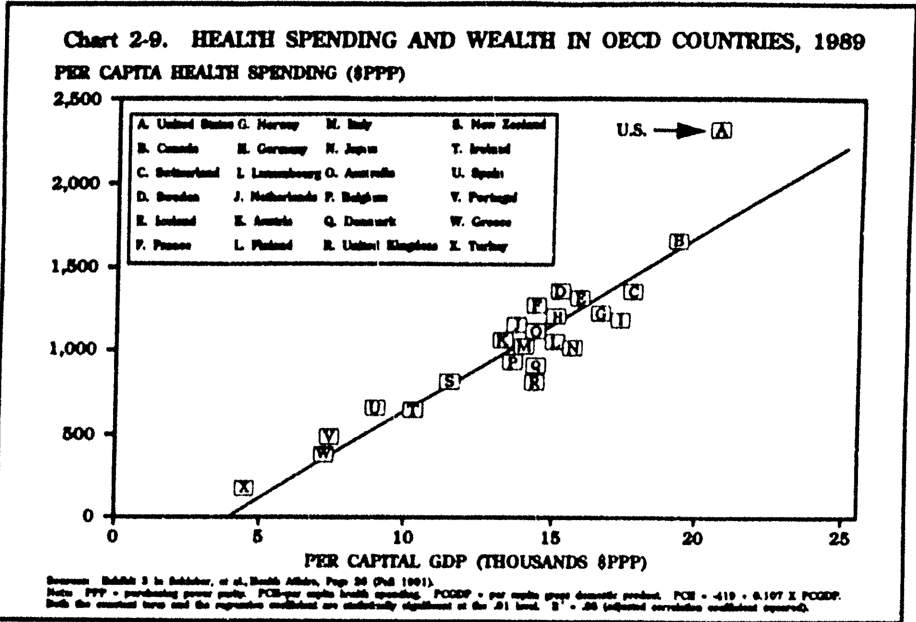


Chart 2-9. HEALTH SPENDING AND WEALTH IN OECD COUNTRIES, 1989
PER CAPITA HEALTH SPENDING ($PPP)
2,500
2,000
1,500
1,000
500
0
U.S.
0
5
10
15
20
25
PER CAPITAL GDP (THOUSANDS $PPP)

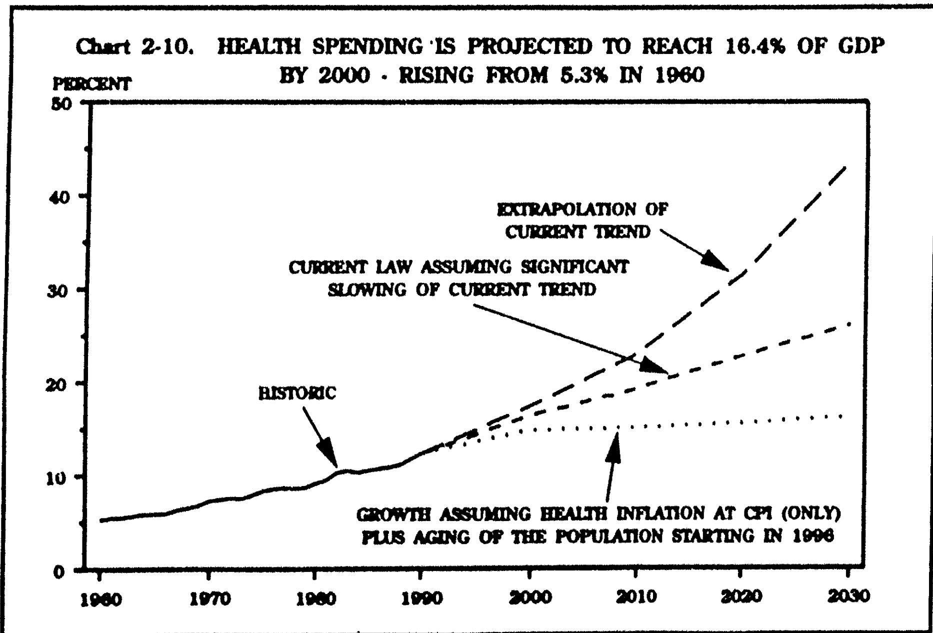


Chart 2-10. HEALTH SPENDING IS PROJECTED TO REACH 16.4% OF GDP BY 2000 - RISING FROM 5.3% IN 1960
PERCENT
50
40
30
20
10
0
EXTRAPOLATION OF CURRENT TREND
CURRENT LAW ASSUMING SIGNIFICANT SLOWING OF CURRENT TREND
HISTORIC
GROWTH ASSUMING HEALTH INFLATION AT CPI (ONLY) PLUS AGING OF THE POPULATION STARTING IN 1996
1960
1970
1980
1990
2000
2010
2020
2030

Notwithstanding the enormous national health expenditure, millions of Americans have inadequate or insecure health insurance coverage. For many middle-income Americans there are reasons to worry that insurance may become unaffordable or unavailable. And for millions of poor and working poor Americans, basic health insurance is already unaffordable. Further, to the extent that federal health expenditures are thought of as filling the financing gap for the needy, there is a basic misconception. In reality, most of the growth in federal health spending has gone to the non-poor. (See Chart 2–11.)

With both the cost and "access" problems in view, the President directed the Secretary of Health and Human Services, Dr. Louis Sullivan, to lead the development of a comprehensive approach to health reform. The President determined that several principles should be applied in this effort.

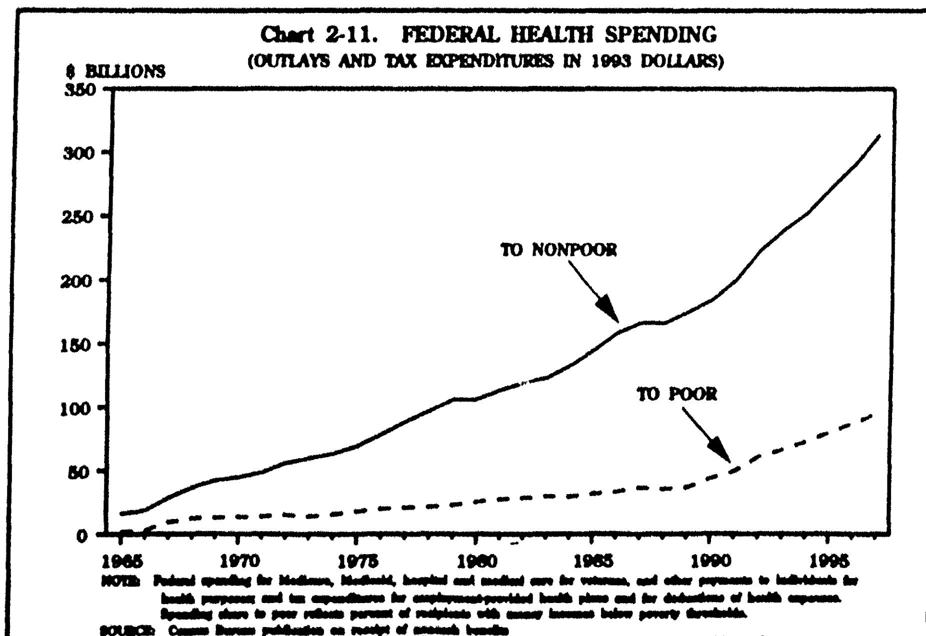
The approach to reform should:

- build on the strengths of the high-quality American health system;
- assure access to basic health insurance coverage for Americans and increase the affordability of such coverage;
- strengthen incentives for cost control and consumer choice;
- emphasize prevention;
- reduce abuse and wasteful excess;
- meet the requirements of fiscal responsibility and budget discipline.

The approach *should not:*

- lead to comprehensive governmental price controls and rationing by government;
- create new spending mandates for states and employers;
- require a net increase in taxes; or
- threaten older Americans with the prospect of either benefit cuts or premium increases.

These tests cannot be met by either "Canadian-style" or "Play-or-Pay" approaches to reform. Such approaches necessarily involve comprehensive governmental price controls, governmental rationing, or major tax increases. Over time, they threaten to degenerate and require a combination of these undesirable characteristics.



NOTE: Federal spending for Medicare, Medicaid, hospital and medical care for veterans, and other payments to individuals for health purposes; and tax expenditures for employment-provided health plans and for deductions of health expenses. Spending share to poor reflects percent of recipients with money incomes below poverty thresholds.

SOURCE: Census Bureau publication on receipt of noncash benefits

By contrast, the President's Plan meets the tests of a responsible approach—without forcing either a major tax increase or a government take-over of the health sector. It gives far greater emphasis to individual *choice* and to incentives for more *cost-effective delivery* of high-quality American health care.

The details of the President's Plan will be released in early February.

RESTRUCTURING AND REFORM— LOOKING BEYOND THE MOMENT

At the moment, the number one concern for most Americans is to get the economy moving again. Understandably, this is the immediate priority. Hence, the President's call for prompt Congressional action on his Agenda for Growth.

Among other major issues of current concern, perhaps the highest priority is to reduce the burden of rising health costs. Hence, the President's Plan for comprehensive health reform.

These two areas of concern have received the most attention in the discussion above—as they have in decisions about the allocation (and reallocation) of budgetary resources. It is likely that they will also be the predominant focus of near-term Congressional interest. The American political system is better designed than any to reflect the public's concerns of the moment.

This is thoroughly appropriate. If the political system acts responsibly in these areas of current concern, it will not only make the economic lives of most Americans better in the near term. It will also go a long way toward relieving the current sense of uncertainty and insecurity—the sense of worry noted at the start of this Introduction.

But a President's Budget must not only address concerns of the moment. It must also look toward the future.

Whether explicitly or implicitly, a budget inescapably addresses the future. In responding to current concerns, for example, a budget might allow debt to rise (as a percent of GDP) without attention to future returns. If there were no such attention to future returns, that would be an important (although regrettable) value statement. It would implicitly weigh the interests of future generations less heavily than the interests of the present. The President's Budget rejects such a perspective. As each of the President's previous Budgets has done, this Budget explicitly treats both:

- *Hidden Liabilities* (see Chapters 12 through 14); and
- *Investment in the Future* (see Chapters 4 through 11).

In assessing a budget's relationship to the future, one must also look beyond the balance sheet and numbers. Numbers can be misleading. This is true not simply because specific numbers can be wrong (as has been amply demonstrated). It is also true because even their relative proportions can be a poor guide to returns on investment.

Small investments can have large future returns. One might consider, for example, this Budget's investments in high performance computing, materials processing, biotechnology, and a host of other generic areas of research and development. (See Chapter 6.) Several of these have enormous and exciting potential to increase radically both American productivity and the quality of life.

Conversely, the mere fact that an area of investment is large and increasing does not necessarily mean that its return will be high. Education, for example, is an area of investment that should have high future returns. But the history of the past several decades shows that a rise in investment can be accompanied by a decline in performance. In such cases, clearly, one must look beyond the numbers to the associated policies for reform and restructuring. (See Chapter 4.)

As a general matter, particular budget proposals are given greater meaning by reference to the larger policies with which they are associated. The chapters which follow, therefore, attempt to frame the President's budgetary proposals in their larger policy context. They are presented in relation to

longer-term themes that comprise an agenda for restructuring and reform.

Thus, *for example:*

- **Increasing Investment vs. Consumption.** The Budget includes thousands of recommendations for discretionary funding of specific projects—in areas ranging from high-technology R&D to low-technology infrastructure. Although the projects have specific merit, their funding should be understood as part of a larger pattern: *an intended shift (at the margin) away from current consumption, toward investment in the future.* (See Chapters 4 through 11.)
- **Limiting Future Liabilities.** The Budget includes mandatory caps, subsidy caps, accounting reforms, and other such arcane technical modifications to the Budget Enforcement Act. These should be understood as part of the *larger effort to limit the future burden of debt and hidden liabilities.* (See Chapters 12, 13, and 18.)
- **Encouraging Entrepreneurship.** The Budget includes proposals for tax incentives to increase investment in capital assets, R&D, and Enterprise Zones. These should be understood not merely as short-term economic stimuli. They are also part of a *longer-term effort to reinvigorate American risk-taking, pioneering, and the entrepreneurial spirit.*
- **Using States as Laboratories.** The Budget includes seemingly technical proposals to consolidate federal grants to States and to facilitate the use of waivers. These should be seen as part of a larger effort to *take greater advantage of the innovative power of the American federal system by using "States as Laboratories."* (See Chapters 19 and 20.)
- **Fostering Personal Responsibility.** The Budget includes increased investment in crime prevention, drug-abuse prevention, incentives for savings, homeownership, and preventive health. This should be seen in conjunction with a related effort *to strengthen the values and habits of personal responsibility.* (See Chapters 5, 8, 9, 22, and the President's Plan for comprehensive health reform.)
- **Increasing Choice and Competition in Service Delivery.** The Budget includes measures to encourage States to adopt educational funding systems that allow funds to "follow the child" in accordance with parental choice. Similarly, the Budget increases investment in housing vouchers and child care certificates. And the President's Plan for health reform proposes a major shift toward transferrable tax credits for basic health insurance. All such measures should be understood as means to *increase individual and family choice.* They are also necessary to provide bottom-up competitive pressure for innovation and reform. They thus help in the *larger effort to accelerate the cost-effective restructuring of large-scale, bureaucratic service systems. These service systems (as in health and education) are now often inefficient or ineffective—and, in many cases, in need of radical, longer-term reform.*

While the American political system is unrivaled in its sensitivity to current interests, it is often less-than-exemplary in its attention to the longer term. So, one can be relatively confident that the short-term economic agenda will command intense attention. But it may be somewhat more difficult to sustain a focus on the long-term agenda of restructuring and reform.

It is important to emphasize, however, that America's economic difficulties are not merely a function of a cyclical short-term downturn. *Many problems would have demanded attention with or without a recession.* The most important of these, perhaps, is the need to increase America's long-term productivity growth. This is a key to future economic growth, to the capacity to support an improving quality of life, and to American competitiveness in a global economy.

But substantial improvement in productivity will not come quickly or easily. It will demand more than just a tax incentive here or a bridge there. It demands action on the full agenda for restructuring and reform: investing in the future; limiting future liabilities; encouraging entrepreneurship; using States as laboratories; increasing choice, competition, and cost-effectiveness in the delivery

of services; and fostering personal responsibility.

The Budget includes important initiatives in all these areas of reform. They are rooted in policies which seek to remedy current weaknesses by building on traditional American strengths and values. They look not only toward economic recovery for the short-term, but toward a responsible basis for confidence in the future.

RICHARD DARMAN
DIRECTOR,
OFFICE OF MANAGEMENT AND BUDGET

Additional Tables Attached:

Table 2–3: Outlays, Revenues, and Deficits (Excluding Comprehensive Health Reform) ..... p. 25
Table 2–4: Mandatory Outlay Proposals (Excluding Comprehensive Health Reform) ..... p. 26
Table 2–5: Revenue Proposals (Excluding Comprehensive Health Reform) ..... p. 28
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Table 2–3. OUTLAYS, REVENUES, AND DEFICITS (Excluding Comprehensive Health Reform)

(In billions of dollars)

Categories	1991 Actual	1992 Budget	1993 Budget	1994 Budget	1995 Budget	1996 Budget	1997 Budget
Outlays							
Discretionary:							
Domestic	195.4	216.2	224.7	229.3	232.2	236.9	236.8
Defense:							
Department of Defense	309.0	300.4	278.7	270.2	269.6	271.8	274.4
Other Defense	10.7	12.5	12.9	13.4	13.9	14.7	15.3
Total Defense	319.7	312.9	291.6	283.7	283.5	286.5	289.8
International	19.7	20.1	20.6	21.4	21.3	21.5	21.2
Total Discretionary	534.8	549.2	537.0	534.3	537.0	544.8	547.8
Mandatory:							
Deposit insurance	66.3	80.1	75.7	-25.0	-27.2	-21.7	-32.2
Federal retirement	75.8	78.3	81.1	85.6	88.7	91.2	96.4
Means-tested entitlements	62.6	74.8	77.4	82.5	87.5	89.4	95.5
Medicaid	52.5	72.5	84.5	98.2	113.7	131.1	150.7
Medicare	102.0	116.0	126.5	140.1	156.0	176.2	197.7
Social Security	266.8	284.3	299.7	315.1	330.8	347.4	364.8
Unemployment insurance	25.3	32.0	25.6	26.0	24.7	24.3	24.6
Other	-57.7	-10.9	-4.6	-12.0	-17.8	-28.2	-24.9
Subtotal Mandatory	593.7	727.2	765.9	709.5	756.3	809.6	872.6
Net Interest *	194.5	198.8	213.8	231.0	242.2	253.0	263.2
Total Outlays	1,323.0	1,475.1	1,516.7	1,474.8	1,535.5	1,607.5	1,683.6
Revenues	1,054.3	1,075.7	1,164.8	1,263.4	1,343.5	1,427.5	1,501.8
Deficit	-268.7	-399.4	-351.9	-211.4	-192.1	-180.0	-181.8
Deficit/Surplus (excluding interest)	-74.2	-200.6	-138.1	+19.6	+50.1	+73.0	+81.4
Deficit/Surplus (excluding deposit insurance & interest)	-7.9	-120.5	-62.4	-5.5	+22.9	+51.3	+49.3
Memorandum							
Deficit on an accrual basis	-268.7	-365.2	-332.7	-242.8	-217.8	-193.7	-203.3
Social Security (included above):							
Operating Surplus	53.5	50.2	63.4	75.9	86.9	101.1	115.0
Interest	20.2	23.9	27.0	31.1	35.7	41.1	47.4
Total	73.7	74.1	90.4	107.0	122.6	142.2	162.4

* Slight variation from estimates printed in appendices due to a late correction in the rate of redemption of State and local governments' holdings of Treasury Securities.

Table 2–4. MANDATORY OUTLAY PROPOSALS (Excluding Comprehensive Health Reform)

(In millions of dollars)

	1992	1993	1994	1995	1996	1997	1992–97
Agriculture:							
Commodity Credit Corporation: reduce subsidies to those with off-farm income over $100,000	-5	-65	-150	-150	-150	-150	-670
Food stamps: effect of increased child support enforcement (net)	0	0	0	-5	-30	-33	-68
Agriculture marketing service: user fees	0	-7	-10	-10	-10	-10	-47
Child nutrition: more equitable distribution of school lunch subsidies	-1	6	5	2	-5	-18	-11
Cooperative State Research Service: eliminate Merrill-Nelson funds	0	-3	-3	-3	-3	-3	-15
Commerce:							
Patent and Trademark Office: extend user fee surcharges	0	0	0	0	-107	-107	-214
Corps of Engineers:							
Expand existing user fees for day use of developed recreational sites	-10	-20	-20	-20	-20	-20	-110
Education:							
Guaranteed student loans:							
Extend the current law elimination of the statute of limitations on collecting defaulted loans	-266	0	0	0	0	0	-266
Net cost from GSL loan limit increase and other policy changes	0	3	151	208	255	277	894
Energy:							
Power marketing reform: recover the Federal Government's financing costs by changing PMA debt repayment practices	0	-380	-452	-453	-456	-454	-2,196
Alaska Power Administration: pay-as-you-go effect of asset sale	0	0	10	11	11	10	42
HHS:							
Family support program:							
Improve the child support enforcement system	0	-134	-149	-164	-181	-186	-814
Raise the asset limit to $10,000 for families already on AFDC and allow families on AFDC to exclude some income and resources needed to meet the objectives of a "self-support" plan at State option (includes Medicaid and food stamp effects)	0	6	26	71	72	74	249
Limit AFDC emergency assistance to statutory limit provided in one 30-day period every 12 months	0	-39	-40	-41	-41	-42	-203
Medicaid: enhance medical support for children	0	-5	-10	-10	-15	-15	-55
Medicare:							
Place hospital update on calendar year basis	0	-630	-1,050	-1,160	-1,210	-1,330	-5,380
Limit Federal subsidy to 25% of SMI program costs for high income persons ($100K single/$125K couple)	-69	-313	-427	-580	-757	-953	-3,099
Establish a single fee for supervisory anesthesia services	0	-100	-140	-200	-230	-250	-920
Authorize HHS Secretary to adjust DME reimbursements to reflect market factors	0	-20	-80	-110	-130	-140	-480
Reform payment of laboratory services by lowering cap from 88% to 76% of the median and update, as needed to reflect market factors	0	-310	-560	-770	-1,020	-1,320	-3,980
SSI: recover overpayments by withholding other Social Security payments	0	-34	-25	-24	-23	-23	-129

Table 2–4. MANDATORY OUTLAYS PROPOSALS (Excluding Comprehensive Health Reform)—Continued

(In millions of dollars)

	1992	1993	1994	1995	1996	1997	1992–97
Interior:							
Arctic National Wildlife Refuge (ANWR): oil and gas exploration rights	0	0	-2,561	-1	-1,531	-1	-4,094
State of Alaska's share of ANWR oil and gas exploration rights	0	0	1,280	*	765	*	2,045
Coastal communities impact assistance: Outer Continental Shelf (OCS) revenue sharing	0	0	26	37	52	66	181
Justice:							
Civil liberties public education fund: request additional funds required for additional eligible recipients	0	250	0	0	0	0	250
Labor:							
Trade adjustment assistance: consolidated with EDWAA	0	-116	-193	-199	-196	-196	-902
Unemployment insurance extended benefits: expand and extend to December 31, 1992	2,203	2,220	0	0	0	0	4,423
Treasury:							
IRS: uniform application to all taxpayers of 45 day processing rule	-21	-310	-335	-361	-391	-422	-1,840
Veterans:							
Home loans: consider government losses on resale when deciding whether to purchase foreclosed property or pay lenders the guaranty claim, and require veterans who are second and subsequent users to pay a 2.5% fee and 10% downpayment	0	-660	-134	-126	-124	-130	-1,163
Medical cost recoveries: extend sunset on authority to recover costs from health insurers of service-connected veterans for treatment of non-service connected conditions	0	0	-226	-255	-274	-280	-1,034
Pensions: extend eligibility verification with IRS match, reduce benefits to veterans receiving medicaid-covered nursing home care, and other provisions	0	-161	-181	-202	-226	-250	-1,020
Readjustment benefit: provide eligibility for vocational rehabilitation to veterans rated 30% disabled or greater, and restore 9:1 service members' benefit/contribution ratio for contributions to GI bill	0	-43	-49	-59	-56	-60	-267
Federal Communications Commission:							
Spectrum auction	0	0	0	-1,253	-1,665	-833	-3,751
Farm Credit System Financial Assistance Corporation:							
Accelerate system repayments of FAC (bailout) debt	0	-212	0	0	0	0	-212
Office of Personnel Management:							
Civil service retirement: permanently extend elimination of lump-sum option	0	0	0	0	-2,144	-2,926	-5,070
Federal employee health benefits:							
Apply Medicare Part B payment limits to all FEHBP enrollees age 65 and older (not just FEHBP/Medicare dual enrollees)	0	-85	-40	-75	-85	-95	-380
Cross-cutting:							
Credit collection reforms	-96	0	0	0	0	0	-96
Subtotal, mandatory proposals (except deposit insurance and PBGC)	1,745	-1,181	-5,336	-5,901	-9,929	-9,830	-30,432
Deposit insurance: expanded powers, interstate banking, and account limitations (accrual basis)	-700	-1,800	-500	-4,400	-5,400	-3,400	-16,200
PBGC: improved funding and changes to bankruptcy status (accrual basis)	-8,700	-2,500	-2,700	-1,700	-3,300	-2,900	-21,800
Subtotal, deposit insurance and PBGC (accrual basis)	-9,400	-4,300	-3,200	-6,100	-8,700	-6,300	-38,000
Total, mandatory proposals (accrual basis)	-7,655	-5,481	-8,536	-12,001	-18,629	-16,130	-68,432

Table 2–5. REVENUE PROPOSALS (Excluding Comprehensive Health Reform)

(In millions of dollars. See Table 2–1 for pay-as-you-go totals that meet the Budget Enforcement Act requirements.)

	1992	1993	1994	1995	1996	1997	1992–97
Jobs and Investments:							
Enhance long-term investment: capital gains	600	3,800	2,100	800	300	-200	6,900
Provide passive loss relief for real estate	-130	-418	-396	-449	-516	-592	-2,501
Adopt investment tax allowance	-6,055	-1,580	3,529	941	810	628	-1,732
Simplify and enhance AMT depreciation	-204	-376	-364	-261	-179	-123	-1,497
Extend R&E tax credit	-183	-823	-1,353	-1,577	-1,804	-2,104	-7,844
Extend R&E allocation rules	-155	-482	-278	—	—	—	-915
Extend low-income housing tax credit	-37	-167	-312	-390	-416	-417	-1,739
Extend targeted jobs tax credit	-56	-154	-161	-92	-48	-26	-537
Extend business energy tax credits	-*	-42	-27	-7	8	8	-70
Extend first-time farmer bonds	-*	-*	-*	-*	-*	-*	-1
Establish enterprise zones	—	-50	-160	-310	-520	-750	-1,790
Facilitate real estate investments by pension funds and others	-*	-*	-*	-*	-*	-*	-*
Repeal luxury tax on airplanes and boats and repeal diesel fuel exemption [1]	-7	15	14	12	8	7	49
Families, Health, Education and Savings:							
Permit deduction of interest on student loans	-56	-443	-655	-721	-796	-882	-3,555
Establish flexible IRA accounts	112	481	66	-371	-989	-2,096	-2,796
Promote retirement saving and simplify taxation of pension distributions	82	28	5	279	365	389	1,148
Waive penalty for withdrawals from IRAs for medical and educational expenses	-22	-118	-123	-126	-128	-131	-648
Extend health insurance deduction for self-employed	-57	-246	-261	—	—	—	-564
Extend HI coverage to State and local employees [1]	344	1,567	1,545	1,548	1,544	1,543	8,091
Double and restore adoption deduction	-*	-3	-3	-3	-3	-3	-15
Expand public transit exclusion	-7	-12	-13	-14	-15	-17	-78
Homebuyers:							
Provide credit to first-time homebuyers	-201	-2,087	-2,536	-637	167	110	-5,163
Allow deduction for loss on sale of principal residence	-41	-412	-392	-372	-354	-336	-1,907
Waive penalty for withdrawals from IRAs for first-time homebuyers	-5	-79	-97	-117	-125	-92	-515
Extend mortgage revenue bonds	-1	-20	-62	-82	-77	-78	-315
Other:							
Support revenue neutral tax simplification	—	—	—	—	—	—	—
Revise rules for charitable contributions	-37	108	116	126	144	166	622
Conform book and tax accounting for securities inventories	245	597	758	778	796	826	3,992
Disallow interest deductions on corporate-owned life insurance loans	121	269	386	521	591	650	2,538
Prohibit double dipping by thrifts receiving Federal financial assistance	360	417	57	4	-40	143	931
Equalize tax treatment of large credit unions and thrifts	103	177	187	197	208	219	1,091
Modify taxation of annuities without life contingencies	42	156	239	318	409	512	1,676
Expand communications excise tax [1]	15	82	86	91	96	102	472
Extend orphan drug tax credit	-2	-12	-13	-14	-15	-16	-72
Establish FCC non-application processing fees	—	71	71	71	71	71	355
Extend abandoned mine reclamation fees	—	—	—	—	228	251	479
Increase employee contributions to CSRS	—	448	1,053	1,216	1,219	1,209	5,145
Conform definition of compensation under Railroad Retirement Tax Act to that of social security	—	13	17	17	17	17	81
Implement Uruguay Round	—	-4	21	13	-50	-86	-106
Total effect of proposals (excluding personal exemption)	-5,244	721	3,052	863	908	-1,103	-789
Personal exemption ($500 per child)	—	-4,356	-4,553	-4,740	-4,998	-5,176	-23,819
Grand total	-5,244	-3,635	-1,501	-3,867	-4,090	-6,279	-24,608

* $500 thousand or less.

[1] Net of income tax offsets.

Table 2–6. PROPOSED SPENDING BY AGENCY (Excluding Comprehensive Health Reform)

(In billions of dollars)

Agency	1992[1]				1993			
	Discretionary		Mandatory Outlays	Total Outlays	Discretionary		Mandatory Outlays	Total Outlays
	BA	Outlays			BA	Outlays		
Cabinet Agencies:								
Agriculture	14.9	14.0	47.8	61.5	14.4	14.4	45.0	59.4
Commerce	3.0	3.0	-0.1	2.9	2.9	3.0	-0.1	2.9
Defense-Military	282.0	300.5	-5.8	294.7	267.9	278.7	-0.8	277.9
Education	22.6	20.9	5.6	26.5	24.3	22.6	7.8	30.4
Energy	18.9	17.8	-1.9	16.0	19.4	18.4	-1.9	16.5
Health & Human Services	29.9	30.3	513.8	544.1	29.3	30.8	554.4	585.2
Housing & Urban Development	24.7	22.9	1.3	24.2	23.7	25.5	2.7	28.1
Interior	7.1	7.2	*	7.2	6.5	6.7	*	6.7
Justice	8.8	8.3	1.1	9.4	9.7	9.3	1.1	10.4
Labor	9.4	9.5	34.7	44.2	9.4	9.5	28.3	37.8
State	4.3	4.2	0.3	4.5	5.0	4.8	0.4	5.2
Transportation	14.2	33.1	0.3	33.4	12.8	34.2	0.3	34.5
Treasury	9.6	9.6	2.1	11.6	10.2	10.2	2.7	12.9
Veterans Affairs	15.6	15.2	18.4	33.6	16.3	16.1	18.1	34.1
Major Agencies:								
Corps of Engineers	3.6	3.4	*	3.4	3.5	3.5	*	3.5
Deposit Insurance	*	0.1	80.1	80.2	*	0.1	75.7	75.8
Environmental Protection Agency	6.7	6.1	-0.1	5.9	7.0	6.4	-0.2	6.2
General Services Administration	0.4	0.6	-0.2	0.4	0.5	1.4	-0.2	1.2
National Aeronautics and Space Administration	14.3	13.8	*	13.8	15.0	14.1	*	14.1
Office of Personnel Management	0.1	0.2	35.9	36.1	*	0.1	37.5	37.6
Small Business Administration	0.8	0.7	-0.2	0.5	0.5	0.6	-0.3	0.3
Other Agencies:								
Executive Office of the President	0.2	0.2	*	0.2	0.3	0.3	*	0.3
Foreign Assistance and related programs	26.7	12.9	-0.7	12.2	13.7	12.7	-0.7	12.0
Judicial Branch	2.2	2.2	0.2	2.4	2.6	2.6	0.2	2.8
Legislative Branch	2.4	2.4	0.4	2.8	2.5	2.5	0.3	2.8
Other Independent Agencies	11.2	10.3	33.0	43.3	10.7	10.7	35.9	46.6
Allowances	0.0	0.0	-0.1	-0.1	-0.5	-0.4	0.0	-0.4
Undistributed offsetting receipts	0.0	0.0	-38.8	-38.8	-1.4	-1.4	-40.1	-41.5
Net Interest	0.0	0.0	198.8	198.8	0.0	0.0	213.8	213.8
Total	533.9	549.2	926.0	1,475.1	506.3	537.0	979.7	1,516.7

[1] Includes impact of supplementals and recissions

* $50 million or less

Table 2–7. DISCRETIONARY PROPOSALS BY APPROPRIATIONS SUBCOMMITTEE

(In millions of dollars)

Appropriations Subcommittee	1992 Budget [1]		1993 Budget		Change 1992 to 1993	
	BA	Outlays	BA	Outlays	BA	Outlays
Domestic Discretionary						
Commerce, Justice, State and Judicary	15,971	15,519	16,578	16,619	607	1,100
Defense	75	59	—	13	-75	-46
District of Columbia	700	690	688	698	-12	8
Energy and Water	9,860	9,251	8,910	8,452	-950	-799
Interior	13,141	12,610	12,486	12,475	-655	-135
Labor, HHS, Education	60,563	59,467	61,985	61,848	1,422	2,381
Legislative Branch	2,343	2,338	2,494	2,435	151	97
Rural Development, Agriculture	11,812	11,071	11,166	11,172	-646	101
Transportation	13,764	32,435	12,368	33,500	-1,396	1,065
Treasury-Postal Service, and General Government	11,050	11,329	11,217	12,124	167	795
Veterans Affairs, HUD, Independent Agencies	65,408	61,430	65,748	65,927	340	4,497
Allowances	—	—	-662	-624	-662	-624
Less Designated Emergencies and Desert Shield/Desert Storm amounts	-1,931	-1,372	-142	-544	1,789	828
Total Domestic Discretionary ("BA Freeze")	202,757	214,827	202,936	224,196	179	9,368
International Discretionary						
Commerce, Justice, & State—Funcition 150	4,978	4,886	5,661	5,477	683	591
Foreign Operations	15,683	13,697	15,144	13,724	-539	27
Labor, HHS, and Education	11	12	11	11	—	-1
Rural Development, Agriculture and Related	1,484	1,474	1,323	1,378	-161	-96
Less Designated Emergencies and Desert Shield/Desert Storm amounts	—	-60	—	-23	—	-57
Total International	22,156	19,989	22,139	20,568	-17	579
Defense Discretionary						
Defense, including Military Construction	281,987	300,429	267,957	278,748	-14,030	-21,681
Energy and Water, Function 050	11,980	11,685	12,132	11,901	152	216
Commerce, Justice, State and Judiciary	234	227	487	466	253	239
Transportation	207	225	203	186	-4	-39
Veterans Affairs, HUD, and Independent Agencies	335	336	322	329	-13	-7
Less Designated Emergencies and Desert Shield/Desert Storm amounts	-10,356	-17,135	—	-5,522	10,356	11,613
Total Defense Discretionary	284,385	295,767	281,101	286,107	-3,284	-9,660
Total Discretionary	509,298	530,583	506,176	530,870	-3,122	287

[1] FY 1992 amounts include supplemental and rescissions submitted subsequent to the FY 1992 Budget.

Table 2–8. FEDERAL EMPLOYMENT IN THE EXECUTIVE BRANCH[1]

(Full-Time Equivalent Employment)

Agency	Fiscal Year			
	1991 actual	1992 estimate	1993 estimate	Change 1992 to 1993
Civilian Cabinet Agencies:				
Agriculture	110,316	111,882	111,021	-861
Commerce	38,988	35,594	35,682	88
Education	4,630	4,927	5,032	105
Energy	17,790	19,950	19,950	—
Health and Human Services	121,121	125,784	125,704	-80
Housing and Urban Development	13,601	14,331	13,837	-494
Interior	72,346	74,900	74,000	-900
Justice	84,073	94,286	97,958	3,672
Labor	17,720	18,241	18,265	24
State	25,409	25,895	26,012	117
Transportation	66,010	70,134	70,212	78
Treasury	160,192	162,949	161,984	-965
Veterans Affairs	217,665	220,641	221,818	1,177
Other agencies (excluding FDIC and Postal Service):				
Agency For International Development	4,347	4,562	4,454	-108
Corps of Engineers	27,241	27,725	27,444	-281
Environmental Protection Agency	16,323	17,622	17,917	295
General Services Administration	19,704	20,013	19,858	-155
National Aeronautics and Space Administration	24,149	24,737	24,947	210
Nuclear Regulatory Commission	3,300	3,335	3,377	42
Office of Personnel Management	5,762	6,156	6,156	—
Panama Canal Commission	8,551	8,603	8,603	—
Small Business Administration	4,887	4,697	4,637	-60
Tennessee Valley Authority	22,273	25,000	23,000	-2,000
United States Information Agency	8,226	8,543	8,679	136
All other agencies[2]	38,125	40,453	40,413	-40
Subtotal, Civilian employment (excluding FDIC and RTC)	**1,132,749**	**1,170,960**	**1,170,960**	—
Federal Deposit Insurance Corporation and Resolution Trust Corporation	12,130	16,300	16,969	669
Defense—military functions[3]	969,059	938,669	897,772	-40,897
Total, Civilian employment in the executive branch	**2,113,938**	**2,125,929**	**2,085,701**	**-40,228**
Military (uniformed personnel):				
Defense	2,125,731	1,929,870	1,807,506	-122,364
Coast Guard (Department of Transportation)	37,653	38,920	39,417	497
Total, uniformed personnel	**2,163,384**	**1,968,790**	**1,846,923**	**-121,867**
Grand total, executive branch employment	**4,277,322**	**4,094,719**	**3,932,624**	**-162,095**

[1] Excludes developmental positions under the Worker-Trainee Opportunity Program; participants in the Cooperative Education Program, disadvantaged and part-time workers under such Office of Personnel Management programs as Summer Aides, stay-in-school, and junior fellowship; and certain statutory exemptions. Totals do not include Postal Service Employment of 757,798 in 1993—down 6,670.

[2] Includes 108 FTE's as a contingency allowance in 1993.

[3] By law (10 U.S.C., Chapter 4, section 140b), the Department of Defense is exempt from full-time equivalent employment controls. Data shown are estimated.

Table 2–9. ECONOMIC PROJECTIONS ASSUMING PRESIDENT'S PROGRAM [1]

(Calendar years; dollar amounts in billions)

	Actual 1990	Projections						
		1991	1992	1993	1994	1995	1996	1997
Gross Domestic Product (GDP):								
Levels, dollar amounts in billions:								
Current dollars	5,514	5,675	5,926	6,307	6,712	7,141	7,589	8,064
Constant (1987) dollars	4,885	4,848	4,919	5,066	5,218	5,374	5,532	5,689
Implicit price deflator (1987 = 100), annual average	112.9	117.1	120.5	124.5	128.6	132.9	137.2	141.6
Percent change, fourth quarter over fourth quarter:								
Current dollars	4.1	3.5	5.4	6.5	6.4	6.4	6.2	6.1
Constant (1987) dollars	-0.1	0.2	2.2	3.0	3.0	3.0	2.9	2.8
Implicit price deflator (1987 = 100)	4.2	3.3	3.2	3.4	3.3	3.3	3.2	3.2
Percent change, year over year:								
Current dollars	5.1	2.9	4.4	6.4	6.4	6.4	6.3	6.1
Constant (1987) dollars	1.0	-0.8	1.5	3.0	3.0	3.0	2.9	2.8
Implicit price deflator (1987 = 100)	4.1	3.7	2.9	3.3	3.3	3.3	3.2	3.2
Gross National Product (GNP):								
Levels, dollar amounts in billions								
Current dollars	5,524	5,689	5,938	6,319	6,726	7,156	7,604	8,070
Constant (1987) dollars	4,896	4,860	4,929	5,076	5,228	5,386	5,544	5,701
Implicit price deflator (1987 = 100), annual average	112.9	117.1	120.5	124.5	128.6	132.9	137.2	141.6
Incomes, billions of current dollars:								
Personal income	4,680	4,832	5,037	5,378	5,712	6,084	6,458	6,854
Wages and salaries	2,739	2,810	2,943	3,134	3,335	3,548	3,771	4,002
Corporate profits before tax	332	313	341	423	456	493	524	556
Consumer Price Index (all urban): [2]								
Level (1982–84 = 100), annual average	130.7	136.2	140.2	144.8	149.4	154.2	159.2	164.1
Percent change, Q4/Q4	6.2	2.9	3.1	3.3	3.2	3.2	3.2	3.1
Percent change, year/year	5.4	4.2	3.0	3.3	3.2	3.2	3.2	3.1
Unemployment rate, civilian, percent: [3]								
Fourth quarter level	5.9	6.9	6.8	6.4	6.0	5.7	5.3	5.3
Annual average	5.5	6.7	6.9	6.6	6.1	5.8	5.4	5.3
Federal pay raises, January, percent	3.6	4.1	4.2	3.7	4.7	4.7	4.5	3.5
Interest rates, percent:								
91-day Treasury bills [4]	7.5	5.4	4.1	4.9	5.3	5.3	5.2	5.1
10 year Treasury notes	8.6	7.9	7.0	6.9	6.7	6.6	6.6	6.6

[1] Based on information available as of January 10, 1992. These projections differ slightly from those of early December, which were used to prepare the detailed budget estimates (see Appendix One, Chapter 8, "Explanation of Estimates").

[2] CPI for all urban consumers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic adjustments to individual income tax brackets.

[3] Percent of civilian labor force, excluding armed forces residing in the U.S.

[4] Average rate on new issues within period.

PREPARED STATEMENT OF WILLIAM L. FISHER

Mr. Chairman and Members:

I am William L. Fisher, Director of the Bureau of Economic Geology and Professor of Geological Sciences at The University of Texas at Austin.

I.

I want to address briefly the current status of U.S. energy supply and demand, the future energy outlook relative to the Nation's economy, and the steps necessary for maintaining productive capability, including certain changes in the Tax Code.

At the present time, oil supplies are ample and ready. In real terms, prices for natural gas, gasoline, and oil products are among the lowest in a decade and a half and, of course, positive to the economy in the short term. Domestic supplies of natural gas have exceeded demand for the past seven years, and since 1985, even with substantially reduced levels of drilling, reserves have been added in excess of production. Domestic oil production in the lower 48 states, in decline since the oil price collapse in 1986, has stabilized, albeit at a reduced level. In 1991, oil production was actually up in the lower 48 for the first time since 1985 and up in Texas for the first time in two decades. Some of this increase was in response to higher prices induced by the Iraqi War, but not much. For the past five years, oil reserves added in the lower 48 have essentially equaled production, and critically, average reserve to production ratios in recent years are at the highest level since the late 1960's. Coal production is now two-thirds greater than in the early 1970's and since 1984 has been the Nation's largest source of domestically produced energy (33 percent), followed by natural gas (27 percent), and oil and liquids (26 percent).

Substantial strides have been made in energy conservation and efficiencies in use. Since the 1973 oil embargo, U.S. GNP has increased 50 percent in real terms, but energy consumption has increased less than 10 percent and is one-quarter less per real dollar of GNP. Oil consumption today is slightly less than in the early 1970's, and natural gas consumption, ironically in this age of environmental concern, is 15 percent less. Net imports of petroleum products now run about 42 percent of total U.S. petroleum demand, or lower than peak level of imports in the late 1970's.

The Nation's ability to produce energy is substantial with current total domestic production the highest in history. Coal reserves have long been viewed as ample, and remaining U.S. oil and natural gas sources, judged scarce and rapidly depleting in the 1970's, are viewed by most analysts to be substantial in the aggregate. In fact, the average of several recent estimates, assuming moderate prices ($25/bbl for oil and $3/Mcf for gas) and advanced technology, peg the potentially accessible remaining oil reserves at 120 Bbo and gas at 875 Tcf, equivalent to nearly 50 years of production at current levels. At somewhat higher prices and with advanced technology, a greater volume of the remaining resource base is accessible.

With the inefficiencies that came with higher and rapidly increasing drilling levels in the late 1970's and early 1980's behind us, the influence

of long-term advances in technology and technologic deployment has returned. Over the past five years, U.S. operators have added about 5 MMboe per annual operating rig, a level 2.5 times greater than that at the beginning of the last decade. Gas drilling over the past six years is barely half the level averaged in the late 1970's and early 1980's, and the average wellhead prices, in real terms, are the lowest in 15 years. Still, gas reserve additions have equaled in volume additions made when gas drilling and prices were higher. Since the oil price crash in 1986, oil drilling has managed only 40 percent the level of the early 1980's. Yet, oil reserve additions in the lower 48 states have been about 85 percent of the level during higher volume drilling. In fact, recent additions per completion in the lower 48 states exceed the all-time average since the beginning of oil and gas drilling in the United States. Further, as reported by Arthur Andersen, finding costs for U.S. oil and gas companies from 1988 through 1990 have been marginally lower in the United States than abroad.

II.

On the face of it, the U.S. energy situation looks reasonably good and in fact many positive elements, like increased efficiencies and recognition of a larger resource base, are fundamental. Others, like prices, import levels, and production levels, are quite illusory. It is, to me, central to U.S. energy policy that we make keen distinction between the fundamental and the illusory, between the shorter and the longer terms. In such manner, the strength of our domestic producing capabilities, which are considerable, can be appreciated and the problems of the moment, which are also considerable, can be rectified.

In fact, if one couples the recent OTA projections of U.S. petroleum production and consumption with EIA's projections of oil prices, imports climb to 73 percent of consumption at an annual price tag of $900 billion (then current dollars) by 2020. Further, the cumulative volume of import dollars projected over the next 30 years exceeds $10 trillion, well above the sustaining ability of even the U.S. economy.

Low oil and gas prices unquestionably have a positive impact on our consuming-oriented economy, but if they are too low to maintain our production capacity over the longer term, which they are, long-term costs will greatly exceed short-term benefits.

III.

Oil prices are widely and rightfully perceived to be volatile despite relative stability in recent months. The extent of stability of oil prices, absent U.S. involvement, is wholly dependent on the desire of the OPEC to provide such stability, and much more critical than their desire, their ability to finely balance short- and long-term supply and demand and to preclude physical interruption. As a result, domestic operators do, and indeed must, discount prices for that uncertainty. As a result, the amount of oil drilling conducted in the United States since the middle 1980's is about 25 percent less than it would have been had prices been perceived to be stable. This translates into a substantial social cost. It need not be, for a stable $20 price is no more costly to the consumer than a volatile price that averages $20. Yet, the volume of domestic resource development is less when unstable prices must be discounted. The plea for price stability has been made by many over the past decade; that it has gone unheeded does not lessen its criticality and economic propriety.

Natural gas prices have fallen to extraordinarily low levels. The situation is caused by combination of rather stagnant demand and the ability of operators to reduce finding costs and to add reserves at relatively low prices. Although our ability to add reserves and produce gas at lower prices, chiefly through advanced technology, is positive, the current collapse of prices is triggering significant decline in drilling activity. Obviously, a reduced drilling effort over even the intermediate time frame will lessen reserve additions and gas productive capability.

IV.

Many resource analysts and estimators believe, as I do, that the U.S. oil and gas resource base is sufficient to support increased natural gas production and stable oil production over the next four to five decades and to do so at moderate costs, provided that prices are stable and perceived to be so; access for exploration is assured; provisions in the tax code are supportive and not counterproductive; and research and development, especially in oil and gas recovery, are pursued with vigor. The steps to be taken are not necessarily Herculean, but they need to be dedicated and firm if a vital energy production capability in the United States is to be secured.

1. Oil prices should be stabilized at about $20 per barrel in real terms. Such a level is near the current price and well below the projected future prices of EIA and other analysts and thus is not inflationary. With the United States, as a major consumer and producer, stabilizing prices, the likelihood of world prices falling below the U.S. support base is not great. But such stabilization would bring domestic resource development to a level about 25 percent greater than has occurred in recent years. The single rationale for stabilization is that market forces can set oil prices only in the widest of ranges, say $8 to $50 per barrel, given the wide range in distribution of oil resources and productivity. As a result, oil prices have been set historically by one government or the other or some combination and will continue to be so set or attempted. A stable moderate price is in the interest of both consumers and producers, and the United States, as the world's largest consumer and yet one of the world's largest producers, has the most at stake and should take the single lead.

2. Access to domestic frontier areas, now chiefly offshore and in Alaska, is essential to maintaining U.S. oil and gas productive capability. The President's National Energy Strategy, as well as introduced but unpassed Congressional legislation, called for opening to lease of part of the Arctic National Wildlife Refuge in Alaska, a site of potentially large oil reserves. Frontiers like this need to be open to exploration and development if stable domestic production is to be achieved. Further, promising areas of the OCS are now off limits by either Executive Order or Congressional moratoria. Such actions are totally inconsistent with maintained productive capacity despite what other aims might be accomplished.

3. Historically, the U.S. Tax Code has been used extensively to encourage the development of the U.S. oil and gas resource base. In oil and gas, as in other areas of the economy, such use of the Code has been demonstratively in the interest of the Nation. But tax incentives have been substantially reduced over the past decade, and even significant

disincentives, like the AMT, are in place. It is clearly the independent, smaller operator who would benefit from such incentives and who does most of the more marginal resource development. The removal of disincentives would significantly revitalize the endangered independent operator, an essential ingredient for maintaining U.S. productive capability.

4. While the remaining U.S. oil and gas resource base is large in the aggregate, it is, by its geologic nature, convertible to proven reserves in relatively small increments. Economies of scale that characterized earlier giant field discovery onland in the United States (and now characterize much of the OPEC production) constitute very little of the remaining U.S. resource base. Remaining economies are those of efficiency, and efficiency must be largely based on advancing technology and increasing the ability to deploy both existing and advanced technology optimally. The average of several recent estimates of the U.S. oil resource base, under assumptions of existing technology and oil prices of $25 per barrel, is 71 Bbo. At the same price, but under the assumption of advanced technology, the accessible volume is increased by 70 percent. The difference is 50 Bbo, the equivalent of 25 years of lower 48 production at current rates. At a price level of $3 per Mcf of gas, the volume of the gas resource base accessible by advanced technology is 50 percent greater than with existing technology. In fact, for much of the remaining oil and gas resource base, recovery is as sensitive to technology as it is to price, above a moderate price threshold.

The biggest potential for reserve additions of oil and significant potential for gas is in areas of improved recovery from existing fields and reservoirs. Improvement of recovery is almost wholly dependent on technology and the ability to deploy it. For example, the President's NES projects an additional increment of 3.8 MMb/d of oil production over the next 15 years; this increment, if achieved, would result in oil production 15 years hence almost 50 percent more than otherwise projected by the NES and almost 30 percent greater than at present. Of the 3.8-MMb/d increment, a massive 85 percent is projected to come from advanced recovery of oil from existing reservoirs. Such a goal, or something near to it, is achievable in context of the recovery resource base, but it will require a substantially greater growth effort than is now being contemplated. Specifically, tax incentives should be provided to revitalize corporate sector research, and public expenditures for oil and gas recovery research need to be expanded and focused.

- Tax incentives were enacted recently by the Congress to encourage the deployment of certain kinds of extraction technologies, so called enhanced oil recovery (EOR). Such incentives are appropriate but should be extended to the advanced geophysical detection technologies. Most of the oil expected to be recovered in the United States over the near and intermediate term is conventionally movable oil trapped in isolated compartments of geologically complex reservoirs. The deployment of advanced geophysical detection technologies, like 3-D seismic, cross-borehole tomography, logging through casing, and several other technologies, will allow sophisticated geologic reconstruction of these complex reservoirs and the resulting ability to develop the kind of reservoir model that will allow the

recovery of substantially more oil economically. Clearly, these technologies should be encompassed by the EOR credit, and I urge the Congress to express its view affirmatively on this subject. An elaboration is provided by attachment to this statement. Further research and development tax credits of a persuasive nature should be put into place to encourage private research and development in oil and gas recovery. According to a 1988 NPC study, the U.S. industry spent an average of $160 million annually and directly on oil and gas recovery research from 1980 through 1988. That volume is now substantially reduced, and much of it has also been redirected abroad. The amount now expended on recovery research is on the order of 0.1 percent of the produced value of domestic oil and gas. Corporate research and development needs to be revitalized.

o Public sector research and development in oil and gas recovery needs to be expanded substantially from its current, essentially insignificant levels. Federal expenditure for oil and gas recovery research, on which the NES relies very substantially, is less than $50 million per year. The Gas Research Institute (GRI) expends about $50 million in gas supply research, about half of which is on recovery research. Thus, the combined amount spent on oil and gas recovery research by (1) GRI, (2) the Federal government, and (3) industry is substantially less than the Federal expenditure alone on coal research and clean coal technology on renewables, and even a much smaller percentage of the amount expended by the Federal government on nuclear energy research. In addition to expanding both private and pubic oil and gas recovery research, efforts to transfer the results of research and technology, especially that conducted at public expense, to users, must be dedicated, focused, and enlarged.

V.

Many of the underlying fundamentals for domestic oil and gas are positive. I say that with full recognition that drilling rig counts are approaching historical lows, oil prices are perceived as volatile, natural gas prices are inordinately low, major companies are redirecting their exploration efforts abroad, and independent operators are besieged by an inappropriate direction of the tax code and financing difficulties. But we should not lose sight of our pluses else we assure the demise of U.S. productive capability.

The resource base is adequate if it is made accessible, and technologies are significantly increasing the ability of operators to add reserves per unit of effort. Sustaining U.S. production for the long term, as called for in the NES, is well within reach if certain steps, relatively modest, are taken and held to. For example, if the current level of efficiency in adding oil and gas resources could be maintained while increasing the annual rig count to 1,500, annual reserve additions would amount to 7.5 Bboe of oil, gas, and liquids, sufficient to support a U.S. production level of 8.2 MMb/d of oil and liquids and an annual production of natural gas at 22 Tcf. The critical "ifs" are increasing rig count while maintaining efficiencies.

If steps are not taken and soon, much more of the U.S. production capability of oil and natural gas will slip away and U.S. dependence upon and vulnerability to foreign sources will increase to staggering and unsupportable levels.

Thank you, Mr. Chairman.

TAX INCENTIVES FOR IMPROVED OIL RECOVERY TECHNOLOGIES

Background

Currently, the average recovery of oil from known U.S. reservoirs is about 35 percent. In short, for each barrel of oil being produced today there are, on average, two barrels of oil left in the reservoir for possible future recovery. This volume of unrecovered oil in known domestic reservoirs exceeds 300 billion barrels. By any measure, it forms a substantial resource target and if it indeed can be successfully attacked, affords the Nation a considerable opportunity to reduce its dependency on imported oil.

Portions of the remaining oil are and will be added to producible reserves. Just how much is, to a large extent, dependent on the degree of understanding we develop in reservoir architecture and its control on fluid behavior and how fully we exploit that understanding in actual field drilling. An ultimate recovery of 50 percent of original oil in place, up from the current 35 percent, is not beyond expectable technological grasp. Indeed, the 50 percent recovery benchmark should be adopted as a long-term goal, to gauge increasing efficiency of the industry, as we move toward full development of our hydrocarbon resources.

Improved Oil Detection Technologies Are Needed

Much of the Nation's unrecovered oil lies in geologically complex reservoirs. Simply put, as reservoirs become more complex, the recovery of oil falls substantially. Thus, a detailed understanding of these complex reservoirs, so that current and advancing technology can be deployed, is essential to more efficient recovery of oil. The key to developing better understanding of these reservoirs lies in greater use of existing, and the development of new, detection technologies, which can provide information for development of geological reservoir models.

For geologically complex reservoirs, the breakthrough technologies, at least over the near- and mid-terms, will be chiefly the detection techniques--high-resolution geophysics, especially downhole, cross-borehole tomography, through-casing logging, and the like--that will allow construction of accurate geological models of these complex reservoirs to guide strategic infield drilling for unrecovered, conventional oil and gas during advanced secondary recovery. These same models are ultimately necessary in efficient deployment of enhanced oil recovery (tertiary) techniques for use in tertiary recovery, too.

Tax Incentives Directed to Detect Technologies Should Be Adopted

Congress, in the 1990 Federal Tax Act, made a significant start toward providing incentives for some advanced recovery techniques, particularly the 15 percent tax credit for tertiary enhanced oil recovery applications. Importantly, Congress delegated to the Secretary of the Treasury the authority to define the scope of qualifying tertiary recovery methods. The Independent Petroleum Association of America (IPAA) and the Texas Producers and Royalty Owners Association (TIPRO) and others have urged that the Secretary act under Section 193(b)(3) of the Federal Tax Code to list, as qualifying tertiary techniques, recovery methods that take into account advances in enhanced recovery technology.

Specifically, the Secretary and his delegatee, the Commissioner of the Internal Revenue Service, have been urged to include the following techniques:

High-tech Reservoir Characterization--The modern technological era has paved the way for advanced methods of reservoir characterization, new processes that will allow the domestic

petroleum producing industry to improve dramatically the advanced recovery of discovered oil and gas. Traditionally, petroleum is recovered through primary, secondary, and tertiary methods--including thermal, miscible, and chemical techniques--that have been identified and defined over many years. Now it is possible through expensive but available reservoir characterization techniques to enhance one or more of these traditional methods substantially, depending on the reservoir analyzed.

High-tech reservoir characterization and recovery management is achieved through application of advanced well logging including:

a. New sonic log techniques that define reservoir rock porosity and presence of hydrocarbon.

b. Resistivity through casing logs to evaluate oil and gas saturation.

c. Acoustic borehole imaging and microresistivity scanning to define thinly interbedded lithologies and natural fractures.

High-tech characterization is also achieved through advanced geophysical detection technologies that define the reservoir framework of both stratigraphic and structural boundaries. These technologies include:

1. 3-D seismic surveying, cross-borehole tomography, or 2-D seismic swath surveying for onshore reservoir development.

2. Advanced 3-D geocellular reservoir computer modeling for reservoir simulation.

In addition, the following means for substantially increasing recoveries through advanced techniques were submitted to the IRS for consideration as qualifying tertiary techniques:

1. Precision drilling to pinpoint location of well sites without regard to traditional spacing requirements. This may involve cluster well sites, tight spacing, horizontal drilling, pattern changes, and location of injection and production wells to improve sweep efficiency.

2. Channel blocking with polymers and cross-linkers using injection and/or high permeability "streaks" to improve sweep efficiencies, and occasionally, using foams and other gels.

3. Immiscible Non-Hydrocarbon or Inert Gas Displacement using carbon dioxide, flue gas, or exhaust gas, or supplemental injection of water or other fluids. Also, injection of microbes and/or nutrients into the oil-bearing zone along with use of enzymes and reagents, in situ generated surfactants and/or solvents, and in situ generated polymers or gums. Plugging of "thief" zones to improve sweep factors should be recognized as part of the process.

4. Actual extraction of reservoir rock to the surface and separation of the oil by retorting, solvents, and surfactants. This mining process should also include horizontal drain holes drilled at the base of the producing formation or below to recover the oil by gravity drainage.

Conclusion

Currently, the Nation provides some tax incentives for producers to use existing enhanced oil recovery or extraction techniques, such as chemical and carbon dioxide injectants, for tertiary recovery. Incentives for such existing techniques clearly should be continued. But to increase the recovery of more moderate cost oil in geologically complex reservoirs, which should be the Nation's major resource target, advances in detection technologies will be critical. These advances will lead to better geological models that will, in turn, enable the industry to more

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efficiently locate and complete wells aimed at unrecovered conventional oil. In addition to improving recovery efficiency of the lower cost conventional oil, advanced geological models will also serve as the foundation for improved application of enhanced oil recovery techniques directed toward the high cost portion of the resource base, through existing tertiary recovery processes.

Clearly, the payback to the Nation from tax incentives targeted toward improved oil detection technology and geologic modeling capability promises to be substantial. Support for these proposed incentives for detection technologies and other advanced recovery techniques should be expressed to the Secretary of the Treasury and the Commissioner of the Internal Revenue Services as qualifying under the 1990 Act. If these officials conclude that these methods were not intended by Congress to be encompassed by the 1990 amendments, then Congress should immediately proceed to expressly list such methods as qualifying for the 15 percent tax credit applicable to existing tertiary methods.

PREPARED STATEMENT OF ROBERT G. GILBERTSON

The American Electronics Association (AEA) was founded in 1943 by 25 California electronics firms. Since that time, AEA has grown to represent more than 3,000 companies located in technology concentrations throughout the United States.

AEA member companies are all based in the U.S. and span the breadth of the electronics industry, from silicon to software to all levels of computers and systems integration. The giants of the industry—for example, IBM, Hewlett-Packard, Motorola, and AT&T—are AEA members. At the same time, 65 percent of AEA members are small to medium sized entrepreneurs with less than 125 employees and less than $10 million in annual sales.

Data Switch designs, manufactures, sells, and services high-speed connectivity devices that allow users of mainframe computers to assure continuous availability of computing capability throughout their complex networks. Virtually every major airline, bank, brokerage firm, and large manufacturing firm in the world uses Data Switch products to assure their twenty- four hour a day operations.

Founded in 1977, Data Switch currently employs 650 employees, most of whom work in Connecticut. Data Switch has 21 offices in the United States and several in Europe. Approximately 30 percent of Data Switch's 1990 revenues of $121.8 million were international, up from one percent of $32.7 million in revenues in 1985.

Mr. Chairman, I want to focus my limited time today on tax policy, capital formation, and the high technology industry. But let me first note that AEA recognizes that any plan to encourage growth must be a comprehensive one. No single tax law—capital gains or any other—will solve our competitiveness problems. We must work with Congress on a broad range of issues related to science and technology, government procurement, trade and so on.

We also realize that industry must do its share—regardless of the policy debates in Washington. We must provide the best in workforce and workplace conditions, and we must insist that the quality of our products is second to none. In this regard, I am delighted to report that the three winners of the 1991 Malcolm Baldrige Award are all members of the American Electronics Association.

I should note, Mr. Chairman, that much of what AEA proposes in the tax area already has the strong support of Congress. On many of our issues, we want simply to encourage your continued support.

Like most of Congress, for example, we agree that the Research and Development Tax Credit represents good public policy. A recent study by two highly respected economists noted the Credit—and this is a conservative estimate—adds $2–3 billion to average annual R&D spending. We need, of course, to make the Credit a permanent part of the tax code since only then will its incentive value be fully felt.

On the research and development allocation rules, we again want to encourage the support you have demonstrated but also urge that you make the moratorium on the 861 rules a permanent part of the tax code. In this regard, AEA was disappointed to see the moratorium extended for only 18 months in the president's budget. The electronics industry believes that we should not encourage American companies to move their research and development overseas, which is exactly what the 861 rules would do.

On capital gains, close to 50 members—including many on this Committee—have cosponsored the Enterprise Capital Formation Act. AEA believes this legislation will encourage long-term investment in smaller companies, and we are gratified by the strong support it has received.

One tax area of significant concern is legislation recently introduced in the House. H.R. 3035 requires companies to amortize intangible assets over 14 years. While AEA supports the concept of tax simplification, H.R. 3035—as currently drafted—would deal a major blow to the electronics industry. Unlike many other industries, the electronics industry receives little benefits from the bill's provision to amortize goodwill and going concern value.

More importantly, most high technology intangible assets have economic lives of much less than 14 years. In most cases, actual lives are closer to three and four years. A 14 year amortization requirement will significantly raise our industry's after tax cost of acquiring the technologies essential for our continued success. It will hurt, in no uncertain terms, our ability to compete with foreign nations. We strongly urge that software and other high technology intangible assets be exempted from this bill.

Mr. Chairman, if there is a common theme to AEA's legislative tax agenda it is that we must begin to encourage long-term investment in R&D and new technologies in this country. The need for such investment cannot be overstated. The U.S. electronics industry—the technological engine driving U.S. manufacturing—has been steadily losing jobs and market share in recent years. The U.S. production share of electronics has declined by one third since 1985. This translates into the loss of over 250,000 manufacturing jobs. Moreover, U.S. leadership in electronics is under serious challenge and may soon be eclipsed by Japan.

One of the most telling benchmarks of American competitiveness pertains to the ability of emerging companies to raise capital. The bottom line is that American entrepreneurs—in today's financial environment—are unable to do so.

The lack of capital availability, of course, can be seen in the decline in institutional venture capital financing. The peak year for institutional fund raising by the industry was $4.2 billion in 1987; in 1990 $1.8 billion was raised; and, in 1991 $1.34 billion was raised. This dramatic decline also can be seen in the number of small emerging companies that were financed with professional venture capital since 1986. The peak in the number of companies attracting investment occurred in 1987 when venture investors funded 1,737 new and growing companies. That number has declined every year since, so that in 1990 just over 1,000 such businesses were funded.

More importantly, however, has been the withdrawal of the individual or the "informal" investor from the long-term, high risk marketplace. These informal investors are citizens with median incomes of $90,000 who typically provide over 90 percent of start-up capital in small companies. They are, I should note here, very sensitive to the tax rates of their investments.

Mr. Chairman, I cannot emphasize enough the seriousness of American entrepreneurs being unable to raise capital and bring their ideas to market. when equity financing disappears so do emerging companies, taking their jobs and cutting edge technology with them. Entrepreneurs have nowhere else to turn. Generally speaking, the conservative nature of the banking industry precludes banks and other "debt" institutions" as a source of investment capital for emerging companies.

This situation has not always existed. The early and mid-1980s were the Age of the Start-Up, a period when investment in high technology flourished and a period which produced such giants as Sun Microsystems, Microsoft, Compaq Computer, and Conner peripherals. America has benefited from these companies. We have benefited by their exports, the thousands of jobs they have created, the cutting edge technology they have produced. But because of today's scarcity in seed and venture funding, we are failing to create a new generation of such companies.

The reasons for the decline in U.S. capital availability for emerging companies are many and cannot be assigned a single cause.

For one thing, the cost of creating new companies has risen beyond comprehension. A new Coopers & Lybrand survey says that the average equity investment required to start a new company between 1986 and 1990 was $10,400,000. That represents an increase of 49 percent from the amount needed between 1981 and 1985.

Clearly entrepreneurs are also being hindered by a short-term mentality in the financial world. Instead of being challenged on how we can bring our R&D to the marketplace, we are being automatically dismissed for lack of a satisfactory P/E ratio or because we cannot promise returns before the next quarterly statement.

And finally, we are hurt by the elimination of the differential on capital gains. It is no coincidence that equity financing for emerging companies began its precipitous decline following the Tax Reform Act of 1986. While not the only factor, eliminating the differential on capital gains has discouraged long-term investment in smaller companies—companies which are the leading source for job creation in this country.

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It is for this reason that AEA supports a restoration of the capital gains differential and has so enthusiastically endorsed the Enterprise Capital Formation Act.

The ECFA increases capital availability for small companies by providing a 50 percent tax deduction for investors who have gains on the corporate stock of companies with less than $100 million in paid-in capital. The legislation has a five-year holding period to encourage long-term planning, and it provides special benefits for seed capital investments, often the most difficult to attract.

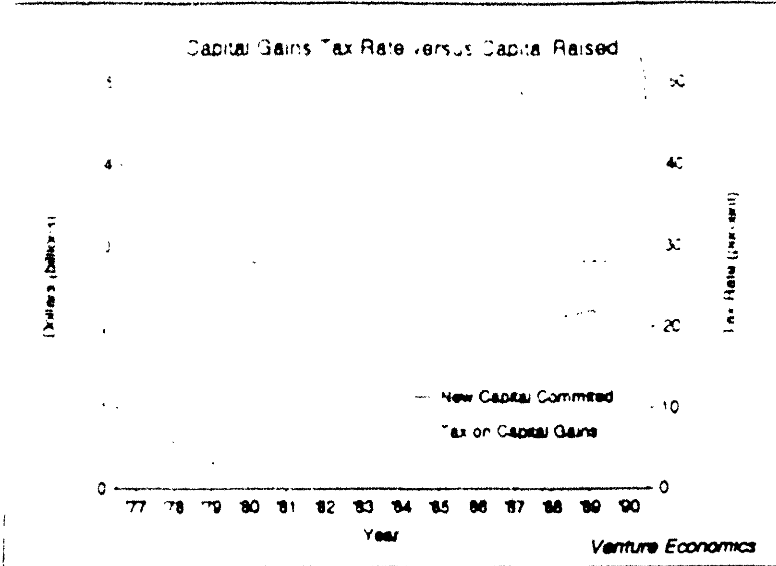
There is, of course, one alternative for financing new technologies. Japanese and Europeans investors have shown, in recent years, a major interest in American technology. As entrepreneurs we accept foreign financing with great trepidation. Such deals often involve giving up exclusive technology rights and control of the company's future direction. Unfortunately, in too many instances, American entrepreneurs are left with no alternative.

Mr. Chairman, helping entrepreneurs find equity financing is, of course, only half the battle. As our foreign competitors well know, continued and accelerating R&D investment must be made to remain competitive. The global economy demands nothing less. Technologies change overnight and unless companies devote enormous resources to R&D, they will fail.

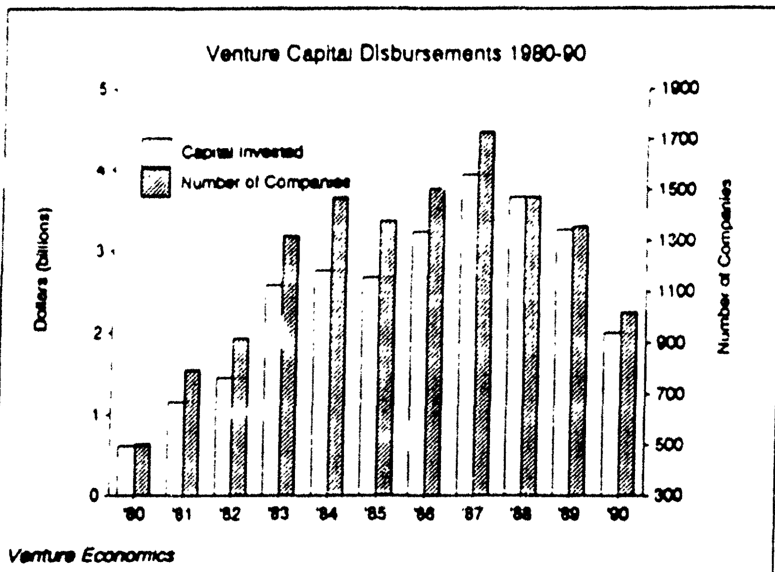
That is why the AEA so strongly supports a permanent R&D Tax Credit and a permanent solution to the 861 allocation rules, and it is why we so strongly oppose the provisions of H.R. 3035 affecting high technology intangibles.

Encouraging long-term investment in U.S. R&D, new technologies, and the ideas of the American entrepreneur. That is ultimately what the AEA is seeking to achieve. We believe no goal can do as much to create jobs or stimulate economic growth

Current Tax Policy is Stifling Long-Term Investments



Capital commitments decrease when tax incentives are repealed.



Investments in new and emerging companies have been declining since 1987. Capital disbursements fell nearly 40% from 1989-1990.

PREPARED STATEMENT OF DORCAS HELFANT

INTRODUCTION

Mr. Chairman and Members of the Committee. My name is Dorcas Helfant. I am the 1992 President of the NATIONAL ASSOCIATION OF REALTORS,® and a resident of Virginia Beach, Virginia. The Association represents virtually every facet of the real estate industry, including REALTOR brokers and salespersons, developers, appraisers, syndicators, and property managers. On behalf of the more than 760,000 Members of our Association, I want to thank you for holding these hearings and for receiving our testimony on the Administration's budget and plan for economic growth.

The President has stated what we believe to be true: real estate can help lead the Nation out of recession. His package contains some provisions that, if enacted, could help shore up a sagging real estate economy. Nonetheless, while his heart is in the right place, the President has made proposals that, in the fine print, could actually further undermine the real estate market. Thus, the NATIONAL ASSOCIATION OF REALTORS did not join with the organizations that endorsed the President's plan. In fact, we oppose some of its features. We note with interest, however, that parts of some of the President's proposals are actually the best parts of bipartisan legislation already supported by many on this committee. *Thus, a primary goal we have today is to urge you to use your own bills, and to act promptly on good ideas that you already support.*

Ten members of this Committee already have cosponsored a real estate industry-backed bill to provide relief from the passive loss rules (S. 1257). Senator Packwood has also acknowledged that the 1986 Tax Reform went too far and has included an important passive loss proposal in his GrowAmerica bill (S. 2120). A huge majority of the Senate has cosponsored the Bentsen-Roth bill to restore Individual Retirement Account (IRA) deductions and to permit a penalty-free withdrawal of IRA funds for the first-time purchase of a home (S. 612). Broad bipartisan support exists, too, for bills to extend expiring provisions for mortgage revenue bonds, mortgage credit certificates, the low-income housing credit and the partial deduction for health insurance premiums. The Chairman has sponsored legislation, which we support, to make the partial health insurance deduction permanent, and to increase it to a 100% deduction. We seek action on this agenda, and affirm our continued long-time support for the goals expressed in those bills and the related elements of the President's plan. We also support reduced capital gains taxes, but add the caveat that current law on depreciation recapture must be retained.

PASSIVE LOSS RELIEF

As a preface to our remarks about passive losses, we note explicitly that the President's proposal is unacceptable and that we oppose it in its current form. Our goal is fair treatment for all people in the real estate business. The President's proposal does not achieve that end.

Before the ink was dry on the 1986 Tax Reform Act (TRA), the real estate industry began its effort to secure relief from the passive loss rules as they might apply to people actively engaged in the real estate business. Chairman Bentsen's efforts during the final deliberations on TRA in that regard had our full support. Now, Senators Boren and Symms have introduced S. 1257, with 10 cosponsors from this committee, and more than 40 Senate sponsors. A companion bill in the House has 323 cosponsors. Two-thirds of the Ways and Means Committee support that bill (H.R. 1414). Senator Bob Packwood (R-OR), author of the original passive loss rules, has also introduced similar legislation providing the type of relief we seek. While we have taken no formal position on Senator Packwood's bill, many of its features are consistent with S. 1257, the legislation supported by a broad coalition of real estate and financial institution organizations. Half of the members of this Committee have thus indicated support for passive loss relief for all real estate professionals. It's time to act.

S. 1257 is far superior to the President's passive loss proposal. The President's proposal is harshly restrictive. First, the President's proposal applies only to a very limited class of developers and operators. While the proposal is inartfully drafted, our reading suggests that most real estate professionals, including many developers, would be excluded. We are even aware of circumstances where some individuals would be more adversely affected under the President's plan than under the harsh rules of current law. S. 1257, by contrast, puts all the people in the real estate business back on a level playing field when they are compared with any other similarly situated business persons.

S. 1257 builds from the known framework of the material participation test, and relies on existing Treasury regulations. The President's proposal, by contrast, would require another set of new, complicated regulations. This is important for several reasons. First, existing regulations provide some clarity as to what constitutes a real estate business. Under current regulations, the universe of people identified as being in the real estate business is far more inclusive than the President's proposal. This aspect of the regulations is settled and non-controversial. S. 1257 is fairly similar to these regulations in their definition of who, in fact, is in the real estate business. The President's proposal departs radically from these settled definitions, and creates narrow, oddly-fashioned rules that are very restrictive. If the goal is to help the real estate industry, the President's scheme is completely inadequate. While it may possibly benefit some individuals, it would not address systemic market weaknesses. Only S. 1257 addresses the broad real estate market.

Another aspect of existing regulations that is important is the rule that permits real property owners to elect to treat each property separately and track income and losses on a property by property basis. This flexibility is an important feature of the regulations because taxpayers can choose the option that best serves their circumstances. The President's proposal removes this flexibility, and requires that the allowable activities be aggregated. This could limit the taxpayer's ability to use currently any losses that might be freed up on the sale of a particular property. Again, S. 1257 is superior, because it retains the flexibility of current law.

A third important aspect of S. 1257's reliance on existing regulations is obvious. The passive loss rules were enacted in 1986. It took the Treasury Department three years and 400 pages to implement the basic regulatory scheme. If the President's passive proposal were adopted, new regulations would be required. Frankly, the real estate industry does not have another three years to spare waiting for Treasury to implement new regulations.

The President's proposal is simply unacceptable. Passive loss relief is essential, and should be modeled on S. 1257. S. 1257 will provide relief to all real estate professionals, not just a few developers.

The Committee is, by now, very familiar with the arguments we have made about the fundamental fairness of passive loss relief and about the importance of this legislation to the real estate industry. We will not repeat those arguments here. During the past few weeks, however, we have encountered two major concerns about passive loss relief. We do want to address them, and put them to rest.

The first concern is that the proposed revision of the passive loss rules would somehow reignite the tax shelter industry. There is no sound basis that we can identify for this concern. A primary objective of the '86 Act was to eliminate so-called tax shelters. No one can precisely define that term, but it seems to refer to some arrangement of lawful tax incentives that, in the judgment of some, unduly combine to reduce the tax burden of an investor in what some deem to be an unfair manner. While there is some disagreement about the role of incentives in a tax-based capital formation policy, there is general agreement that some abuses have occurred and that these abuses have given rise to the disparaging term tax shelter. Tax bills for the last 20 years have addressed those abuses, not only as they occurred in real estate activities, but in many other endeavors, as well.

The Economic Recovery Tax Act of 1981 (ERTA) was extremely generous, and provided incentives that did lead to an over-heated tax environment for real estate. Every broad-based tax bill since that watershed bill, however, has contained provisions that have increased the tax costs of real estate development, and made it substantially more difficult to raise capital for those activities. Many of these were enacted with the sometimes warranted, but frequently overly broad objective of cutting back abuses. Appendix A lists those changes. All of them would remain intact, even if the passive loss rules were corrected using the model of S. 1257. With all of these restrictions in place, we would respectfully suggest to the Committee that there is no tax shelter left.

Providing the industry-wide passive loss relief we seek would correct an acknowledged unfairness. S. 1257 does not amend, overturn, or even affect any of the important provisions enacted to curb abuse. Presently, we are preparing to analyze an actual 1982 tax shelter investment and compare it with what could occur under current law. We expect that study to show that the old "tax shelter" industry could not be revived when we enact passive loss relief. Most of the provisions that drove a 1982 or similar investment are no longer in operation.

The second frequently expressed concern is that somehow enactment of passive loss relief might spark new construction. While more difficult to state with certainty, we do not believe this would be a probable outcome. It is well known that financing for new construction is scarce to non-existent. Refinancing for existing commercial loans is difficult to obtain, even in cases where properties are fully

leased. We believe that a modest change in the passive loss rules for real estate professionals will have no effect whatever on the availability of credit for new construction. Thus, acceleration of new construction, or overbuilding as a result of S. 1257 is, as a practical matter, impossible. We are hopeful that passive loss relief can, however, provide some relief to the credit crunch as it applies to existing financing by freeing up cash flow and relieving some pressure on individuals still carrying troubled properties. Oddly, the President's proposal could, in the absence of a credit crunch, actually stimulate construction because it provides passive relief only for those properties developed by the taxpayer. Such a rule would do nothing to correct current market problems. The current owners of rental properties did not necessarily develop those properties. This is true for both developers and non-developers alike.

Finally, in discussing the passive loss rules, we reiterate that we are looking primarily at the issue of fairness for the real estate industry. Ours is not a capital formation argument, nor are we expressing any intent or desire to return to pre-1987 law. The real estate industry was treated unfairly under the passive loss rules, so changes should be made to remove punitive burdens that treat real estate professionals differently from all other similarly-situated business persons. Changes to current law are essential because current law is indefensible. We will not argue that all of the ills that beset current markets are traceable to this one provision. Rather, we ask the Committee to live up to its own standards of fairness and correct the flaws in the treatment of real estate under the passive loss rules. The President is correct that real estate can lead the nation out of recession, as it has in the past. S. 1257, not the President's proposal, is the best way to do that. At a minimum, Congress must provide passive loss relief to all real estate professionals.

CAPITAL GAINS

In the best of all possible worlds, Congress would not only enact passive loss relief for rental real estate, but it would also reenact a meaningful capital gains differential. An abundance of anecdotal evidence suggests that many individuals who own viable properties and who have held them for a long period, continue to hold those properties rather than sell them and take the tax beating associated with current law. This lock-in of capital exacerbates the perception that real estate markets are dormant or stagnant. We cannot, of course, quantity or measure events that have not or will not take place because of lock-in. The NATIONAL ASSOCIATION OF REALTORS has, however, commissioned research on the effect on real estate values of the Tax Reform Act of 1986, and has discovered that the rules enacted in 1986, particularly passive losses and capital gains, had, by 1990, contributed to property value declines of up to 18%. Since 1990, the downward spiral of values has continued, and many markets have seen values decline by as much as 30%. Our 1990 research has also shown that correcting the tax laws, especially the capital gains and passive loss rules, would provide the biggest "bang for the buck" in the same markets that were most adversely affected by tax reform. Accordingly, we urge Congress to act rapidly to correct these two features of the Tax Reform Act of 1986.

The President's proposal to reduce capital gains taxes does, however, contain one very negative feature. The President proposes eliminating so-called "Section 1250 recapture." Thus, all depreciation deductions previously taken would be included in income and taxed at ordinary rates. In today's market, elimination of that provision of current law would be unwise and unfair. In many circumstances, real estate could be worse off than under current law.

When Congress repealed the capital gains exclusion in 1986, it very deliberately left all of the other superstructure of the capital gains rules intact. The Conference Report to the '86 Act notes that this was a deliberate choice, so that any renewal of a capital gains differential would require only the re-enactment of an exclusion. No wholesale revision of the capital gains framework was deemed necessary or prudent. While we did not agree with the decision to repeal the capital gains exclusion, we do believe that Congress was correct in leaving the capital gains structure intact. We further note that in 1990, when Congress established a very modest capital gains differential, the recapture scheme was preserved. We therefore urge the Committee to adhere to that posture, and to leave the section 1250 rules intact.

The President's proposed change to the recapture rules is, in effect, a change to tax principles that have been settled for 30 years. Worse, his proposal is retroactive in its application, because it changes the rules for all existing properties. We would hope that the fiasco of the passive loss rules would have taught us that retroactive tax increases that apply to real estate serve only to erode values and sap market strength. Changing recapture would repeat a disaster. We urge that current law be retained.

As with the passive loss proposal, the President's capital gains proposal will not unleash the real estate market to lead the nation out of recession. Failure to retain the current recapture rules will have very unfair results in a market where values have sharply eroded. Notwithstanding the very low tax rate for capital gains that the Administration proposes, depreciation recapture at ordinary rates would put real estate in a worse position than it is today. We find it shocking that the Administration would impose a retroactive multi-billion dollar tax on real estate, and thereby tilt the playing field further away from real estate investment by making a proposal that could actually increase the total tax cost of selling property, and also put real estate at a disadvantage as compared with securities and other assets.

While the NATIONAL ASSOCIATION OF REALTORS does support a meaningful differential for capital gains, we can only support it if the end product is what it purports to be: a *true reduction* in capital gains taxes. We could not support a proposal that purports to provide a benefit if, in fact, it provides only a penalty. A capital gains cut proposal that taxed real estate more heavily than current law is just as odious as the 1986 repeal of the capital gains exclusion, and for the same reason: It would be using a change to laws applicable to the real estate industry in order to "pay for" benefits made available to other taxpayers. We categorically and emphatically reject this logic. We therefore urge that any capital gains proposal this Committee acts on retain current law as it pertains to depreciation recapture.

HOUSING AFFORDABILITY

The NATIONAL ASSOCIATION OF REALTORS has long advocated proposals to make housing more available and more affordable to a larger universe of families and individuals. We are profoundly concerned about the declining rates of homeownership in general, and among younger people particularly. To this end, we have long supported the mortgage revenue bond and mortgage credit certificate programs, as well as the low-income housing credit. We therefore support the President's recommendation to extend these provisions another 18 months. We would prefer that they be made permanent, but do nonetheless support this extension.

For several years, we have sought legislation that would permit Individual Retirement Account (IRA) withdrawals for the first-time purchase of a home. We were therefore delighted at the introduction of the Bentsen-Roth bill (S. 612) that permits these withdrawals for not only the purchaser, but the purchaser's parents, grandparents and spouse, as well. We applaud an approach that permits a family to determine how best to use its own resources. The President's proposal would limit withdrawals to $10,000, and would not permit parents or grandparents to use IRA funds to assist their children. S. 612 is superior to the President's proposal, as it permits unlimited withdrawals, and permits withdrawals by parents and grandparents. S. 612 is also superior because it permits withdrawals from other savings plans as well. Taxpayers who participate in so-called Section 401(k) and 403(b) plans would also be permitted to make penalty-free withdrawals.

One further comment on S. 612 is appropriate. S. 612 would restore the IRA deduction for all taxpayers. This is extremely important for several reasons. First, it is crucial to our nation's future that we increase our national savings rate. Growth, investment and, yes, homeownership are only possible if we save and plan for our futures. Second, if taxpayers utilize the expanded withdrawal provisions and draw down from their existing IRAs, then it is extremely important to their own well-being that they replenish those accounts. An expanded IRA provision will provide a means for them to restore those accounts and plan their futures. Finally, restoring IRA deductions sends a strong signal to all Americans that saving for the future is in everyone's best interest, and that saving and investment are viable national policies.

The members of our association have wholeheartedly and eagerly embraced the proposed homebuyers credit. They report increased traffic among first-time homebuyers and increased interest in homeownership. Housing is more affordable than at any time in the past 18 years. Increased homeownership has benefits throughout the economy. Our research shows that the immediate stimulus would be the creation of nearly 500,000 jobs in 1992. The construction and related retail industries are hard-hit presently, so such a stimulus has great merit on both housing and growth policy considerations.

We do add one cautionary note, and so urge you to clarity your intentions quickly and affirmatively. Buyers are staying out of the market while they wait to see what Congress will do. Real estate cannot lead the nation out of recession while buyers sit on the sidelines watching Congress. Whether you accept or reject this credit, we urge you to act quickly so that markets will not be frozen.

If you do adopt the credit, we also urge you to modify its timing for eligible taxpayers. Our research shows repeatedly that the biggest single obstacle to first-time homebuyers is amassing a down payment. As the proposal is configured in the President's proposal, qualifying taxpayers would not receive the benefit of the credit until 1993 and 1994. This does nothing currently to help solve the downpayment problem. We recommend that some sort of provision be adopted that would front load the credit so that the timing of its benefits would more nearly coincide with the timing of the downpayment. One solution would be to permit taxpayers to amend 1990 tax returns, and to claim the credit on 1991 returns as filed or extended.

CONCLUSION

Restoration of values in all real estate markets—commercial, multi-family, and traditional single family residential—is a primary goal of the NATIONAL ASSOCIATION OF REALTORS and the real estate industry. To that end, we think it is crucial to first remove punitive provisions from existing law. The Bush Administration proposals do not address real estate problems in a broad, systemic manner. We believe it will be impossible to have a sound real estate market until all people in the real estate business can deduct their losses from their legitimate business activities. Fair treatment for all real estate properties will make an important and meaningful contribution to creating a better market environment and shoring up our sagging economy. Our priority at this time is to secure passive loss relief as in S. 1257 and a meaningful capital gains differential with current recapture rules. A homebuyer's credit is also a meaningful residential real estate incentive. When all real estate has been placed on a level playing field, all sectors of the market will benefit. We believe this is *sound* tax policy, *not special* tax policy, and urge the Committee to move forward as quickly as possible.

APPENDIX A.—CURBS ON TAX SHELTERS ENACTED SINCE 1981

Since 1982, Congress has enacted a series of provisions aimed at curbing abusive tax shelters. They are as follows:

- Longer depreciable lives for real property;
- Net investment interest limitations;
- Capitalization of interest expense;
- Original issue discount measurements;
- Interest-free loan limitations;
- Limitations on deferred rents;
- Alternative minimum tax (individual and corporate);
- Reduced credit for historic rehabilitation;
- Partnership restrictions;
- Increased information reporting;
- Installment method accounting limitations;
- Completed contract method accounting limitations;
- Cash method accounting limitations;
- Taxable year limitations;
- At-risk rules for real estate.

In addition, two important provisions enacted in 1986 significantly increased the tax costs of both owning and selling real property. These are:

- Passive activity loss limitations
- Repeal of capital gains exclusion

PREPARED STATEMENT OF JOHN J. MOTLEY III

Mr. Chairman, my name is John Motley, and I am the Vice President of Federal Governmental Relations for the National Federation of Independent Business (NFIB). NFIB is the nation's largest small business advocacy organization, representing more than 500,000 small and independent business owners nationwide.

Thank you for this opportunity to testify before the Finance Committee on how small business owners think Congress should react to the current economic situation.

FISCAL RESPONSIBILITY

In anticipation of the upcoming debate over an economic development initiative, NFIB conducted a random sample survey of 5,000 NFIB members in early January. The results of that survey are cited throughout our statement and are based on the over 1,000 responses we received. NFIB's positions on legislative issues are established solely on the basis of the NFIB Mandate and other polling of our members.

NFIB members favor deficit reduction and fiscal restraint over tax cuts and economic stimulus. When asked how Congress should respond to the current state of the nation's economy, 72% voted to reduce the deficit, while only 27% supported cutting taxes. These results are consistent with the responses NFIB has received in its surveys over the last decade.

Small business owners remain concerned about the size of the deficit and the growing national debt. They believe it hurts our international competitiveness and undermines their ability to secure adequate long-term financing. In brief, they are worried about the future.

In a recent letter to President Bush, NFIB President and CEO James Herr expressed NFIB's desire to avoid an economic quick-fix that would be detrimental to our nation's long-term economic health. Small business owners believe that they are heavily over-taxed. They would oppose, however, any tax cuts that would increase the deficit.

At the end of last year, NFIB's Chief Economist, Dr. William Dunkelberg, testified before the Ways and Means Committee. He highlighted several points I would like to share with the Committee.

First, this recession is a natural product of the over production that occurred in the 1980's. During that decade we experienced a great deal of economic growth, and some segments of the economy produced goods faster than they could be consumed. Commercial real estate is a perfect example of this. To a large extent, today's economic slow down is a result of consumers needing time to wear out all the goods they bought in the 1980's.

Second, although the slowing economy has caused a great deal of pain across the country, there is not much the federal government can do to encourage consumers to purchase more than they need. The government, however, can take certain actions to ensure that the recovery will be as strong as possible.

For example, the heavy burden of government regulation is seriously weighing down small businesses. Hundreds of billions of dollars is spent by small firms in trying to comply with a flurry of recently enacted federal laws.

Federal spending is out of control. Congress and the White House must work together to reduce the government's appetite for new funds and prevent the government from going further into debt.

NFIB believes that the President struck the right chord in stressing the need for fiscal responsibility. We strongly support retaining the caps on spending negotiated in 1990, plus freezing the number of federal employees and eliminating programs that are inefficient or no longer needed.

In summary, NFIB strongly urges the Committee to exercise restraint in fashioning its economic development proposal. While reviving the economy is important, care should be taken to insure that this is not accomplished at a price that will damage it in the future.

TAXES SMALL BUSINESSES WANT REDUCED

The political momentum building behind an economic recovery tax package is enormous, and we recognize that passage of legislation is almost a certainty. At the risk of standing in the face of this consensus, NFIB urges that any changes in the tax code be modest and targeted for the express purpose of encouraging investment and long-term economic growth.

According to the Small Business Administration, the American small business community employed 58% of the work force and provided 49% of all new jobs in 1988 (the last year for which complete figures were available). Small firms were the engine of economic growth in the 1980's, and they are the perfect vehicle to restore the American economy in the 1990's.

Convinced that this Committee and Congress will act on an economic recovery tax package this year, I'd like to share with you our thoughts on the changes that can be made in the tax code to spur small business growth.

Individual Rates

While NFIB members are clearly representative of our nation's small business population as a whole, according to our January survey, 56% of NFIB members are either sole proprietors, partnerships, or subchapter S corporations, and as a result, they pay taxes as individuals. Not surprisingly, when they were asked how they would cut taxes, they chose reducing individual income tax rates.

The results of the January survey correspond with similar results NFIB received during an extensive survey of its members before the 1986 tax bill. For the most part, small business owners pay taxes as individuals and would benefit from a reduction in the individual rates.

Making a significant reduction in individual income tax rates would be neither modest nor targeted. The large number of beneficiaries of such a tax cut may make it politically attractive, but it will either be extremely

expensive or so small that it will have little or no effect on the economy. As such, an individual cut in 1992 appears very unlikely.

Since a meaningful income tax cut is probably not in the cards for this year, NFIB urges this Committee to do the next best thing for small business owners, don't raise the rates. An increase in rates would severely impede any recovery in the small business community.

SPURRING SMALL BUSINESS GROWTH -- CUTTING THE COST OF LABOR

Small businesses tend to be labor intensive, and as a result, a disproportionate share of their tax burden is payroll taxes. Reducing FICA taxes would immediately reduce employers' payroll costs, allowing them to increase salaries or hire additional employees.

Payroll taxes have a particularly devastating impact on small businesses that are just starting and struggling to become profitable. Income taxes are based on how much the business earns each year. Payroll taxes, however, are regressive, ignoring the ability of a business or individual to pay.

A study by the NFIB Foundation found that almost half of all new businesses are started with less than $20,000. A business with this little start-up capital will probably have to pay little or no income taxes in its first years, but its payroll tax liability remains constant as long as payroll remains the same. It is never reduced, even if the business loses money.

The burden of Social Security taxes is particularly heavy for the self-employed. Unlike most workers who pay the 7.65% employee share of the FICA tax, the self-employed must pay both the employer and employee share, or 15.3%. This 15.3% surtax on starting your own business severely limits the ability of entrepreneurs to get off the ground.

Reducing FICA taxes will encourage new business formation, allow existing employers to increase their payroll, and put a few dollars back in the pocket of every working American. NFIB strongly urges this Committee to reduce FICA taxes.

Unemployment Insurance

Unemployment insurance benefits were recently extended an addition 13 weeks for those workers who found themselves out of work. This extension in benefits was paid for by drawing down the unemployment insurance trust fund. NFIB members are concerned that reductions in the trust fund will lead to future FUTA tax increases. Unlike FICA taxes, employees pay no share of FUTA taxes. The entire cost of the program is paid for by employers.

All payroll taxes are burdensome for small businesses whether they are used to pay for Social Security benefits or unemployment insurance benefits. They are nothing more than a tax on jobs. NFIB urges Congress to seriously consider the impact any payroll tax increase will have on jobs. If jobs are a priority, we strongly recommend that you reexamine the appropriateness of payroll taxes to fund government programs.

SPURRING SMALL BUSINESS GROWTH -- CUTTING THE COST OF CAPITAL

A number of proposals have been offered to reduce the cost of capital. These proposals will reward investment in business, and as a result, will spur economic growth and employment. From the standpoint of a small business owner, the most important aspect of these proposals is how simple they are to use. A $1,000 tax benefit is of limited significance if a small business owner has to pay $500 to an accountant to figure out how to use it.

Increased Expensing

Internal Revenue Code section 179 allows small businesses to avoid the horrors of the depreciation tables by just writing off the first $10,000 worth of investment they make in their business each year. NFIB has been a strong advocate of increasing expensing to at least $20,000, and higher, if possible.

Increased expensing has all the benefits of other methods of reducing the cost of capital with one very important addition -- simplicity. Expensing is extremely easy to use. Small business owners just deduct any amounts they invest in their business up to $10,000.

The typical NFIB member invests less than $20,000 a year in his business. Increased expensing would allow him to write off virtually all of this investment without having to worry about the complicated rules of depreciation. Of all the methods available to reduce the cost of capital, expensing is the simplest and the best from the small business's vantage point.

Investment Tax Credit

The Investment Tax Credit (ITC) is also an effective way to reduce the cost of capital for small business owners. In our January survey, NFIB members picked reinstatement of the ITC as one of the best ways to encourage new investment. The ITC is also relatively simple to use.

Prior abuses of the ITC have resulted in some policy makers calling for limiting the types of investments for which it would be available. Although restrictions on the use of the ITC may satisfy important tax policy goals, they would also complicate its use to the point that it would be very unwieldy and difficult for small businesses.

NFIB supports the reinstatement of the ITC for small firms. Targeting the ITC to small businesses will limit its cost and greatly increase the probability that it will affect purchasing decisions.

Investment Tax Allowance

The President has proposed spurring economic growth by offering an investment tax allowance (ITA). The ITA would allow businesses to increase the amount they can depreciate in the first year.

While more complicated for smaller firms, increased first year depreciation would also reduce the cost of capital. Its advantages are that it is already the primary depreciation system used by most capital-intensive firms and, it can be implemented quickly and without much confusion.

Reducing the Capital Gains Tax

Small businesses are capital investments. A reduction in the capital gains rate would encourage increased investment in small firms and allow owners who have spent their lives building their firms to take a little bit more away with them when they retire or sell their businesses.

NFIB supports a reduction in the capital gains rate. One of the primary problems any new business has is finding capital. A reduction in the capital gains rate tied to the length of time an investment is held would encourage investors to seek out businesses as investments. Increased investment would spur both business and job creation.

The biggest benefit small business owners will receive from a reduction in the capital gains rate occurs when the time comes to sell the business. Currently a small business owner has to pay up to 28% in tax on the increased value of his firm, even if a good deal of that increase is attributable to inflation.

NFIB supports the approach to capital gains taken by Sen. Bumpers, but we prefer the broader proposal put forward by the President. As mentioned above, a majority of NFIB members are not corporations and would not benefit from proposals that focus exclusively on helping corporations.

SIMPLIFYING THE TAX CODE

The complexity of the tax code and the necessity of having tax professionals review every business decision is a serious burden for small business owners. Simplifying the code and removing some of the needless complexities will allow small business owners to spend more time doing what they do best -- building a business and creating jobs.

Federal Tax Deposit Rules

The General Accounting Office has estimated that one out of every three employers is penalized every year for not complying with federal tax deposit rules. This extraordinary level of non-compliance is the result of the insanely complicated nature of the rules.

Sen. Baucus has already introduced legislation, S. 1610, that would solve this problem by greatly simplifying these rules and allowing employers to determine ahead of time when they have to deposit withheld taxes. NFIB supports Sen. Baucus's approach to this problem and urges the Committee to include it in any tax bill it reports this year.

Independent Contractors

The confusion surrounding the current status of independent contractors is damaging both to the entrepreneurs who desire to work as independent contractors and to the small business owners who hire them.

The tax law throws a large road block in the way of entrepreneurs interested in selling their services by threatening their potential customers with huge penalties. Independent contractor status is the first step toward establishing a business. Yet, those who contract with these budding business owners are subject to IRS harassment and confusion.

Current law acts as a real restraint against the use of independent contractors. The vagueness of the law, coupled with beefed up enforcement by the IRS, places any employer who uses an independent contractor in a very precarious position.

NFIB supports enacting a simple, clear definition of an independent contractor. This will allow an independent contractor who falls within this definition to assure future employers that the IRS will not harass and penalize them.

Pension Simplification

Only one out of every four NFIB members has a pension plan. There are two major hurdles that prevent small businesses from starting pension plans -- the cost of starting and administering the plan and the cost of paying plan benefits.

Several different pension simplification alternatives have been proposed. Most of these proposals adequately simplify unnecessarily complicated administrative rules. NFIB members, however, are unlikely to use any simplified plan that requires them to pay a fixed percentage of employee salary in benefits. Most simply can not afford this.

Small business owners do not start pension plans because the costs involved are too high. To encourage pension plan creation and participation, the costs of administering the plan and paying the benefits must be reduced.

NFIB supports legislation introduced by Sen. Packwood, S. 318, the PRIME retirement account, that would allow small business owners to create a simple, inexpensive retirement plan. PRIME allows small employers to avoid complicated non-discrimination and participation rules as long as they match, dollar for dollar, employee contributions to the plan (up to 3% of salary).

CONCLUSION

Any action taken by this Committee to address our nation's economic problems should be targeted, modest, and take into account the huge size of our budget deficit. In addition, the Committee should address the root cause of the economic slow down. It is not the result of consumers not having another $100 to spend. It stagnated because real demand dropped and people lost their jobs. Revitalizing small businesses is the quickest and surest way to put Americans back to work.

NFIB recommends that the following steps be taken to boost the economy:

* Reduce federal spending. Federal spending acts as a drag on our economy because it results in both higher taxes and government competition with private enterprise for scarce financing.

* Reduce federal regulations. Every hour a small business owner has to spend trying to comply with federal regulations is an hour he cannot spend building his business and creating new jobs.

* Cut the cost of labor. The current tax system penalizes employers for every new worker they hire. It taxes jobs and is a tax we can no longer afford.

* Cut the cost of capital. Businesses can only grow with increased investment. Lowering taxes on investment will funnel funds directly to where they are most needed.

The most important finding of NFIB's January survey may be that 75 percent of the small business owners responding say that they would reinvest any tax cut they receive in their businesses. If after these hearings you decide to cut taxes, NFIB strongly encourages you to target your efforts to small business tax payers. They will give you the biggest bang for the buck; they will invest in America and American jobs.

PREPARED STATEMENT OF SENATOR JOHN D. ROCKEFELLER IV

Congress and the President are striving to deal with very serious economic problems. But I hope in all our efforts here we will keep in mind that people want more than just a feeble increase in economic indicators.

People are looking farther down the road and asking about the lives of their children ten and twenty years from now, and about the lives of their grandchildren.

They are calling for a long term change of course. They are calling for investments that may take years to ripen, such as research in new technology. And they are calling for long term investment in people to enable us to build the America of the next century.

They are calling for investment in human capital, knowing that the engineer we educate today, the worker we retrain today, the child we save from sickness today, is the best insurance we have that America's values will survive and prevail in the new century and the new world opening before us.

This is the strong message from people in the homes and schools and farms and factories across the country. But here in Washington, there is still confusion. There is confusion because the public push for government action comes after years in which Americans have been urged to lower their expectations about government.

The philosophy of do-nothing government has run up against the common sense notion of the American people that its government exists to solve problems and address the country's needs.

And the list of neglected needs is long, from a broken health care system, to an epidemic of child poverty, to anemic economic growth and a lagging ability to prevail in a world of fierce economic rivalry.

I hope that our witnesses today will help us focus on these economic fundamentals. I hope they will focus on what we can do today that will reinforce, rather than undercut, what we need for tomorrow and for the long term.

As the Committee responsible for tax policy, I hope we can look at tax policy as one piece of a broader agenda. We should have learned from the last decade that indiscriminately throwing tax breaks at the economy does not amount to a serious economic program that addresses the full range of our national needs.

We need lower health care costs and higher SAT scores. We need stronger banks and aggressive development of cutting edge technology. Fairer tax laws and carefully drawn tax incentives for more productive investment should be a part of a comprehensive strategy. But let's not waste time on giveaways for paper entrepreneurialism. Let's not pretend that tinkering with the tax code amounts to a serious economic strategy.

We need a well thought out economic program with elements that fit together into a strategy to restore American economic might. The free ride for government is over. The public is demanding action now that will set a new course for the long term.

The measure of our success should be not only what happens in the next weeks and months, but how what we do today affects the condition of the country in the next decade and in the next generation.

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

The importance of these hearings cannot be overstated. For the first time in many years, America is poised for what I call a peaceful revolution—a revolution for which our nation has labored a very long time. Many of the objectives that held our attention even five years ago have been met, and met successfully. Perhaps the most pronounced of these was the resolution of the Cold War.

The people who saw to it that America remained strong and resolute throughout the Cold War, are the same people whose economic concerns must be met now that the Cold War is over. Our immediate need is to create an environment of growth for American workers, for their families, and their industries—the economic life blood of our nation. But not only must we meet this immediate need, we must also take this opportune moment in time—this moment charged with the successes abroad and the desire for reform here at home—and prepare for America's long-term competitive advantage.

Such an agenda must include proposals to increase our national savings rate. It must include proposals to reduce marginal rates in federal income taxes. And it must encourage risk-taking and business ventures. This is how America will create a successful economic future. We cannot tax our nation into prosperity; what we can do is promote an environment of growth. And that can only be done by reducing the ponderous size of government, by reducing needless federal regulation, by promoting efficiency and self-reliance in an atmosphere marked by a lack of confidence in government.

Just as America has realized its successes in foreign policy, just as we have raised technological innovation to a break-neck pace, just as we have performed medical miracles—we will also succeed in creating an environment of growth for both the short- and long-terms. But just as Congress's 1990 record-setting tax increase deepened the recession, further taxes will do to a needed environment of growth what Saddam Hussein did to the environment of the Persian Gulf.

Instead of more and more taxes, instead of more and more spending, what we need are more and more incentives to work, save and invest. Among the many proposals circulating Capitol Hill are three that I believe are critical toward creating such incentives. They include the Super IRA proposal which I introduced with our Chairman, an investment tax credit, and a marginal rate reduction in federal income taxes. The hallmark of each of these proposals is that they are broad-based—not for one exclusive group over another. They benefit across all segments of our economy and create a large dispersion of incentives for economic growth. Such a broad-based approach will stimulate our economy universally—not just pockets of our economy where special interests dictate.

With his March 20th deadline, the President has provided us with a challenge, and we're here to meet it. While I cannot agree with all of them, clearly, the President's economic proposals are taking us in the right direction. Personally, I wish he had gone further in some of his economic proposals, such as income tax reductions and IRA expansion. I'm not suggesting that Congress rubber stamp the President's budget, but given the current economic climate, am saying that we must work with, and build upon, the President's proposals to provide incentives through the tax structure which will improve our ability to compete both today and in the future.

PREPARED STATEMENT OF STEVEN A. WECHSLER

INTRODUCTION: TOWARD RATIONAL TAX POLICIES FOR REAL ESTATE

In 1981—11 years ago—National Realty Committee was invited to testify before this Committee, then engaged in a similar effort to examine the tax code with an eye toward restoring growth to the national economy. While we certainly then shared the view—and do today—that overall economic growth was an urgent aim requiring immediate action by Congress, we said then that special tax incentives were not necessary to ensure the construction of the office buildings, hotels, warehouses and shopping centers that the nation required.

"Frankly," we said in our testimony, "we are concerned that if excessive tax incentives are offered for the construction of nonresidential buildings, the inevitable result will be a boom in tax shelter-motivated investment followed by the inevitable bust resulting from uneconomic overpricing or overproduction." Unfortunately, our concern was all too prophetic as the 15-year accelerated depreciation adopted that year helped fuel the wave of tax shelter-motivated investment our industry experienced over the next five years.

In 1986, as Congress debated tax reform, National Realty Committee again spoke out for rational tax policy for real estate. We applauded the concept of tax reform

and the need to eliminate noneconomic, abusive tax shelters. But we vociferously opposed the passive loss provisions, which overreacted in the extreme to the tax sheltering unleashed in 1981, going so far as to brand all rental real estate activities as "passive". . . regardless of how much time or effort one spends actively involved in the real estate business.

If you understand our views on tax policy today, our views in 1981 and 1986 should come as' no surprise. That's because National Realty Committee—as Real Estate's Roundtable in Washington—takes a long-range approach to policymaking at the national level. Our views on tax policy and other matters are in fact grounded in our commitment to the long-range health of real estate and the national economy.

So pervasive and fundamental is real estate to the way we live that many often take this important national resource for granted. Fortunately, that's not the case today with President Bush. Two weeks ago, in his State of the Union address and FY 1993 budget, he signaled his recognition of the vital role real estate plays in our nation's economy through a set of critically important tax initiatives aimed at stabilizing commercial real estate markets, facilitating homeownership, and encouraging necessary new home construction—all important goals if real estate markets are to recover and help lift the nation out of recession, as it has so often in the past.

Needless to say, many members of Congress have made—and are making—the same points as well, underlining the linkage between a strong real estate sector and the health of the overall economy.

After all, real estate—valued at $12 trillion—is America's greatest tangible capital asset. Real estate generates more than two-thirds of the taxes raised by local governments to support schools, hospitals, roads, and other essential services. The real estate industry, although made up of relatively small businesses, produces about $575 billion of goods and services every year, while employing more than eight million people. And real estate, whether it be our homes, farms, parks, factories, commercial or public buildings, is an asset directly or indirectly owned by a cross section of Americans.

As the past 18 months have dramatized, when real estate suffers, so do people and businesses in all walks of life. And that's what's happening now. Real estate is in trouble . . . as are the banks . . . other financial intermediaries . . . and the economy. Capital and credit are virtually non-existent—even for existing assets. Property values remain in freefall. State and local tax revenues—already strained from federal cutbacks and the recession—are drying up. And, from our point of view, whether we've yet hit bottom is highly questionable.

It would be unfair to say that unsound tax policies alone are responsible for today's real estate crisis. They are not. But what is clear is that a combination of flawed national policies and poor business judgments are at the root of today's problems . . . problems that must be addressed for real estate markets to stabilize and the national economy to recover and grow.

WHERE DO WE GO FROM HERE

As Real Estate's Roundtable, we appreciate the opportunity to offer our views today—to help provide insight to the question before us now, "Where do we go from here?"

In short, our view is that a long-term, rational tax agenda for real estate is necessary to restore stability to today's highly volatile, largely dysfunctional real estate market. Unless and until real estate is on a sound economic footing grounded in sensible and fair tax policies, we believe a meaningful national economic recovery is unlikely.

It is imperative to note that the real estate industry is in no way endorsing a return to the tax sheltering of the early 1980's. Claims that changes to the passive loss or other rules would revitalize the tax shelter industry are misleading at best and ignore the fact that the other numerous tax provisions of the Tax Reform Act of 1986 (and the Deficit Reduction Act of 1984) provide an incredibly effective backstop to this type of activity. Likewise, the legislation we support would not reignite a speculative real estate development boom—new commercial construction, in large measure, is neither needed nor desirable. We know that these issues are all too easy to demagogue and can make for sensational headlines, but assertions that the changes we advocate would bring back tax shelters or spur the construction of unneeded office buildings are simply not supported by facts. Nor are such groundless charges constructive today—they ignore the severe problems facing existing real estate assets, financial institutions, the federal government, and the general economy.

Having said that, the President, in his recent State of the Union address, advocated several responsible tax policy changes that we support and believe are fun-

damentally needed to rationalize the tax treatment of real estate and help put the economy on a growth track. They include modification of the passive loss rules, facilitation of pension investment in real estate, reduction of the capital gains tax, extension of the low-income housing tax credit and other housing-related steps. Members of Congress, including several on this Committee, have also put forward serious proposals on these and other issues that should be included in any legislation to comprehensively address today's economic crisis. Our recommendations are outlined below.

- *Passive loss.* We agree with President Bush and the majority of members of this Committee—the passive loss tax rules should be modified. We believe Congress should adopt S. 1257, introduced by Senators David Boren, Steve Symms and John Breaux. This legislation, which has over 40 Senate cosponsors, would modify the passive loss rules so that individuals engaged in real estate are treated the same as people in other businesses by allowing them to currently deduct losses from rental real estate activities in which they materially participate. We are extremely encouraged that the President has recommended action in this critical area, and believe his passive loss proposal is a major step forward. However, we are concerned that the Administration's proposal, in addition to being narrower than S. 1257, addresses only losses incurred on properties developed by the taxpayer. This falls short of equal treatment for those in the real estate business and fails to address one of todays principal problems—stabilization of existing properties, whether or not developed by the taxpayer.
- *Capital Gains and Depreciation Recapture.* With respect to capital gains, we agree with President Bush and many members of the Committee—the capital gains tax should be reduced. But we completely disagree with the Administration's related proposal to repeal the depreciation recapture rules for real estate that have existed for almost 30 years. Clearly, a lower capital gains tax would be a very effective tonic aimed at economic recovery and the restoration of real estate values. However, the Administration's proposal to repeal the current depreciation recapture rules for real estate substantially reduces the value of such a cut for real estate owners. Because only the gain in excess of all prior depreciation deductions would qualify for a lower capital gains tax under this approach, the effect on an owner selling property for the same amount for which it was purchased would be an 11 percent tax increase over current law. What is worse, ii, as some advocate, Congress increased the top individual tax rate to 35 percent as a trade-off for capital gains, the tax increase on this common transaction would be a whopping 25 percent. This astounding tax increase could not be proposed at a worse time for the real estate industry or the economy—a time when values are substantially depressed and many sales are below, at, or just above cost. Moreover, given the fact buildings really do depreciate over time while nominal values increase due to inflation, requiring full depreciation recapture would be tantamount to eliminating depreciation deductions for real estate—hardly something designed to stimulate the economy or real estate values. Congress should lower the capital gains tax and retain the current depreciation recapture rules.
- *Pension Investment.* We agree with President Bush and many members of this Committee—tax rules should be modified to facilitate prudent pension investment in real estate. As has been suggested by Chairman Bentsen in the past and has been noted by the Administration in its economic growth plan, pension funds, with their long-term liabilities, are a logical source of capital and credit for long-term real estate investment. Yet, several tax and regulatory policies create unnecessary obstacles to such investment. Without undermining protections against undue risk already in place, several rule changes should be made to allow for prudent pension investment strategies in real estate. For example:

—REIT ownership restrictions should be modified to permit domestic pension funds to invest in real estate through REITs on terms equal to those permitted foreign funds. This should be done by amending the "five or fewer" ownership rules to allow domestic pension funds to be counted as more than simply a single investor as is currently the rule for foreign funds and domestic corporations;

—tax rules concerning pension capital investment in debt-financed real estate are too restrictive and should be revised to allow pensions, and other tax exempt organizations, to engage in transactions involving: standard post-closing purchase price adjustments; "cash-flow" or "participating" loans; sale-leasebacks; and, seller-financing. The Administration proposals in this area are significant steps, but we believe more comprehensive proposals are needed. For example,

the Administration proposal to allow leasebacks of up to 10 percent of the leaseable floor space is very helpful. However, modifying this proposal to allow leasebacks of up to 10 percent of gross revenues would be more responsive to situations involving large shopping centers owned by large anchor tenants or an affiliated party. Allowing the type of post-closing price adjustments that are standard in commercial real estate transactions today would provide the type of credit enhancement necessary to attract pension fund investment. Further, the Administration proposal regarding seller financing allows loans with equity participation of up to 25 percent of the loan if a financial institution is the seller, but no equity participation if the seller is a non-financial institution. We see no reason to have a different standard and would urge that the proposal for financial institutions be applicable to all sellers.

—rules controlling partnerships between pension funds and taxable investors, particularly the "fractions rule," should be clarified. Here the Administration has proposed modifications helpful in cases involving large partnerships, but has not addressed the very real problems current law poses for small, private partnerships between taxable and tax-exempt organizations.

- *Secondary Market.* The existing secondary market for real estate debt and equity should be made stronger and more attractive. Strengthening the secondary market for commercial real estate securities would infuse significant capital and liquidity into the banking and real estate sectors of the economy. There are a number of steps the Federal government should take to greatly bolster this market. In the tax area one of the most important changes would be to allow subordinated interests in investment trusts to be tradable. IRS rulings restrict the tax pass-through benefits of "trust" status to cases where the subordinated interest is permanently retained by the issuer and is neither transferred nor traded. This limits the liquidity and reduces the value of subordinated interests. Legislation, or an IRS announcement, is needed stating that the transfer or transferability of a subordinated interest in a fixed investment trust would not affect the classification of the trust.
- *Low-Income Housing.* The tax credit for low-income housing should be made permanent. The on again/off again low Income Housing Tax Credit (LIHTC) is a perfect example of the type of changing federal policy that prevents the construction of affordable housing. The annual battle to extend the LIHTC inhibits more investors and builders from undertaking the arduous task of qualifying for, and winning an allocation for, any given development. Many are simply unwilling to devote the time and manpower necessary to earn the credits for a project when it is uncertain whether or not the LIHTC will even be extended year-to-year.
- *Workouts.* Tax rules that do not unnecessarily penalize real estate debt restructurings or workouts should be adopted. The tax liability associated with debt restructuring, foreclosures, or deeds in lieu of foreclosure generally results in taxes owed in excess of cash received in the transaction. Congress should approve Representative E. Clay Shaw's bill, H.R. 3651, which would allow taxpayers to defer current tax liability in these transactions by reducing the tax basis in other property by the amount of forgiven debt. This would not avoid the tax, but would delay its payment until a sale generated cash to satisfy the liability. This rule existed prior to 1986, when it was repealed for all taxpayers except farmers. It was retained for farmers because of the "credit crisis" that was disabling the farming sector at that time. Real estate should now be equally treated.
- *Leasehold Improvements.* Depreciation rules should recognize the true economic life of leasehold improvements. Taxpayers now are required to depreciate leasehold improvements to real estate over 31.5 years, even though in practice these leasehold improvements have little or no value beyond the expected term of the lease. This makes the after-tax cost of building-out space to accommodate a new tenant artificially high at a time of limited credit availability. In addition, construction employment opportunities are reduced. Congress should permit leasehold improvements to be recovered over the life of the lease term—which is really their true useful life.
- *At-Risk Rules.* The "at-risk" tax rules for banks and thrifts selling real estate held in their portfolios should be clarified. Financial institutions are inhibited from providing financing for the sale of properties held in their portfolios because the at-risk rules do not count any nonrecourse seller financing in determining at-risk amount for buyers, even when its financing provided by a financial institution selling properties held temporarily in its portfolio. Congress should adopt H.R. 3650, introduced by Representative Shaw, allowing

nonrecourse financing provided by institutions selling real estate-owned properties to be treated the same under the at-risk rules as nonrecourse financing provided by a third-party lender.

CONCLUSION

As President Bush and many members of Congress have observed, healthy real estate markets are essential to an overall healthy national economy. With todays credit crisis continuing, real estate values in freefall, and real estate markets largely in disarray, fair and rational tax policies are needed immediately to stabilize the marketplace and put the economy on a course for growth.

It is in the long-term interest of both real estate and the national economy to put in place policies that facilitate prudent real estate investment without opening the door to the excesses of the past.

We believe our views both in 1981 and 1986 reflected this outlook, and we believe our views today are similarly reasonable, responsible, and responsive. We hope you agree.

National Realty Committee serves as Real Estate's Roundtable for national issues vital to the real estate industry. A leading public policy advocate, NRC primarily addresses capital and credit, tax, environmental and investment-related issues. NRC members are America's principal real estate owners, advisors, builders, investors, lenders and managers.

COMMUNICATIONS

STATEMENT OF THE AFL–CIO

The AFL–CIO appreciates this opportunity to present its views on the important subjects of tax policy, and economic growth.

As the recession drags on in an election year, the same Administration which for more than a year denied the recession's existence, then declared prematurely that the recession was over, now proposes to mask the bankruptcy of its economic policies by means of massive tinkering with the tax code. Most of their proposals are ill-advised. In place of programs to create jobs, stimulate the economy, reform the health care system, meet housing needs, and invest in the nation's future, the Administration offers costly and ineffective tax gimmicks, primarily of benefit to corporations and the well-to-do.

These tax gimmicks would be paid for by a combination of spending cuts, accounting tricks, and the creation of enormous and growing tax expenditures in future years. They will provide little of the economic stimulus that this sick economy and the suffering unemployed urgently need. They will further undermine the nation's ability to meet its long-neglected public investment requirements.

THE NEED FOR AN ECONOMIC RECOVERY PROGRAM

The stimulus so obviously needed would be provided far more effectively on the budget's expenditure side. This recession is not going to go away by itself. The economy is locked in a vicious downward cycle of production cuts, job loss and reduced consumer spending. Only vigorous government action will break that cycle. Congress and the President should act *immediately* to develop and implement a recovery program that will create jobs, repair the nation's crumbling infrastructure and get this economy moving again. As the AFL–CIO explained more fully on January 9 in testimony before the Senate Budget Committee, history tells us the best way to lead this nation's economy out of recession is through fiscal stimulus—"priming the pump" with an immediate shot of direct government spending for desperately needed, job-creating public works projects and for maintaining the purchasing power of the unemployed.

We believe this short term strategy of investing in the rebuilding of America's infrastructure, its public services and its social safety net, should be combined with other long term measures to put the economy on a solid footing and make the nation more productive for years to come.

The AFL–CIO recommends an *immediate* overall fiscal stimulus program in the neighborhood of one percent of Gross National Product—about $60 billion—to be spent on (1) ready-to-go-projects for infrastructure, (2) housing and (3) aid to state and local governments to maintain services.

Cities and states require emergency federal funds to forestall further public service cutbacks; infrastructure projects must be accelerated to provide jobs now while meeting public investment needs; the unemployed urgently need a further extension of benefits; and housing programs which have been allowed to languish must be revived.

Spending programs for infrastructure create as many as 22,000 jobs per billion dollars of expenditure. Half of these jobs would be in the hard-hit construction industry, where unemployment has skyrocketed to 16.3%; the other half would be in industries ranging from manufacturing to mining, and from transportation to services. Under the Surface Transportation Act of 1991, only $23 billion of spending is scheduled for 1992. Much of the spending scheduled for later years can and should be accelerated to create jobs now, while adding lasting value to the nation's economy.

To get these projects started quickly, any existing state and local matching-fund requirements should be waived. Expenditures for public works at the federal, state

and local levels should also be accelerated and expanded, and federal funds for this purpose should be provided immediately. According to economist David Aschauer, the nation's infrastructure needs have been neglected so badly that every additional dollar spent on infrastructure at this time would stimulate between two and five times as much economic growth as would an additional dollar of private investment. [1]

UNEMPLOYMENT INSURANCE BENEFITS

To alleviate the suffering of the jobless and their families, a further extension of unemployment benefits is urgently needed. The extension currently being considered by the Congress is a modest step in the right direction, but it does not go far enough. The Emergency Federal Unemployment Compensation Act of 1991 should be extended until unemployment falls below 6% with additional benefits of 26 weeks for all beneficiaries. In past recessions, a far higher proportion of the unemployed received benefits, and the duration of benefit eligibility was far longer than is the case today.

While it is important to extend these benefits, this emergency program highlights the serious weakness of the nation's unemployment insurance system. Three out of every five of the nation's unemployed workers simply do not get unemployment insurance. We urge this committee to reform the unemployment insurance system. Initial coverage should be expanded by removing the many criteria used currently to disqualify workers. The recommendations of the 1980 National Commission on Unemployment Compensation should be enacted as basic federal minimum requirements, including a requirement that state benefits be no less than two-thirds of the state's average weekly earnings.

ADDITIONAL ELEMENTS OF COMPREHENSIVE RECOVERY PROGRAM

In addition, a comprehensive recovery program should include the following components:

- Reform of the nation's health care system, including cost control and guaranteed access to basic health services for all Americans.
- A tax cut for the middle-class that would be paid for by raising rates on the wealthiest one percent of Americans.
- Implementation of a realistic trade policy that supports rather than undermines American jobs and industries.

ADMINISTRATION PROPOSALS DO NOT PROVIDE STIMULUS

These are the elements of an economic recovery program worthy of the name; the Administration's tax proposals most emphatically are not. In the current economic climate, with household debt and joblessness so high, and consumer confidence, job security and income growth so low, even the meager portion of the Administration's proposed tax cuts that would flow through to taxpayers of moderate means would likely be used to pay off debt, rather than be spent. As eminent economists Francis Bator and Robert Solow noted recently, tax cuts would provide only a weak stimulus to the economy at the present juncture. They estimate that a dollar of tax reduction is likely to generate only 30 to 40 cents of additional consumer spending, in contrast to the emergency countercyclical federal aid to the states and cities which they forcefully advocate. [2] Nor are tax breaks for business likely to spur new investment, if the prospects for increased sales, production and profits remain so bleak. To the extent that the proposed tax cuts would be paid for by cuts in spending, they will not provide any stimulus to the economy at all, rather they would eliminate jobs.

Indeed, the impending reduction in military spending, however desirable on other grounds, will cause further job loss in the already-weak economy unless it is offset by well planned economic conversion and new public spending on infrastructure and other programs to create badly needed jobs. The resources freed up by reductions in military spending are far too valuable to be relegated to the growing scrapheap of closed factories, or the lengthening lines of the unemployed. They must be redirected to help the cities and states, to reform health care, to improve education, and invest in housing.

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[1] Aschauer, David Alan, "Public Investment and Private Sector Growth," *Economic Policy Institute*, 1990, pp. 2–3.

[2] Bator, Francis and Solow, Robert, "Two Ways to Wake Up the Economy," *New York Times*, December 4, 1991.

MIDDLE CLASS TAX CUT

While tax cuts are not the best form of economic stimulus at this juncture, working taxpayers of moderate means clearly need and deserve a tax cut on equity grounds. It should be paid for by means of higher taxes on the well-to-do.

The purchasing power of workers' earnings has fallen $64 per week or 16% since the 1970s; family incomes for the bottom 60% of the income pyramid have decreased. Incomes of the well-to-do, by contrast, have increased sharply. Between 1977 and 1989, pretax incomes rose 47% for the nation's richest 5%. For the richest 1%, pretax incomes rose 77%, to $560,000. Their 13% share of the nation's economic pie has grown as large as the slice received by the entire bottom 40%. Yet while workers at the base of the income pyramid faced sharp increases in regressive payroll taxes and state and local taxes, the federal tax rate on the richest one percent fell by 25%.

The sums involved are far from trivial in terms of the nation's revenue needs. It is estimated that tax cuts since 1977 will be worth an average of $83,000 this year alone to each of the nation's richest one per cent of taxpayers.[3] The resulting drain of public resources amounts to the huge sum of $164 billion per year, including $84 billion of tax revenues directly foregone plus $80 billion in interest payments on the cumulative increase in federal debt which has been incurred as a result of these tax cuts for the super-rich.

Of the numerous tax proposals unveiled during the last few months, including those contained in the President's State of the Union address, the AFL–CIO finds that only two, the refundable payroll tax credit and the refundable per child tax credit, restore a measure of fairness to the tax code without absorbing resources needed for other more pressing purposes. They are far superior to the President's gimmicky plan to change the withholding schedule, and his minimalist, inequitable proposal to increase the personal exemption. We urge adoption of both the payroll and per child tax credits with offsetting increases in taxes on the richest one percent so that the net impact over the next five years is revenue-neutral. If the tax cut provisions of both plans are adopted as the AFL–CIO urges, a working family in the 15% tax bracket with two children will get a tax cut of as much as $1,310 per year this year and next year, and $910 per year thereafter.

The payroll tax credit proposal would cut taxes by up to $400 per year for middle income working taxpayers this year and next year. The cut would be provided in the form of a refundable federal income tax credit equal to 20% of employee-paid social security and medicare payroll taxes, up to a maximum credit of $400 for joint taxpayers, or $200 for individuals.

The contrast between the refundable payroll tax credit proposal and the President's tax withholding gambit is sharp. The payroll tax credit would provide hard-pressed working taxpayers with modest but real relief; the President's will provide many of them with a nasty surprise in April 1993, after the election, when the short-term loans from the IRS must be repaid.

The AFL–CIO also supports replacing the personal exemption for children up to age 18, currently $2,300, with an $800 refundable credit per child. Replacing the exemption with a credit would be worth $455 per child to taxpayers in the 15% bracket, $156 to taxpayers in the 28% bracket, and $87 to taxpayers in the 31% bracket. The Earned Income Tax Credit (EITC) for working poor families needs to be expanded for working families.

The Administration's initial proposal to raise the personal exemption for dependent children by $500 with a deferred effective date of October 1 is distinctly inferior to a refundable tax credit. It would provide a pittance or nothing at all to taxpayers who need relief the most; taxpayers in the 15% bracket would receive a $75 tax cut per child, as against $455 per child under the $800 tax credit proposal. Fully 25% of the nation's children, including most or all who are being raised in poverty, live in households that would get nothing at all under the Administration's proposal, because unlike the $800 tax credit, the increase in the personal exemption would not be refundable. Only affluent taxpayers in the 31% bracket would do slightly better under the Administration's proposal than with a tax credit; they would receive a $155 per child tax cut, as against $87 under the tax credit. For 1992, the 31% bracket starts at taxable income of more than $82,000 for joint taxpayers.[4]

Tax cuts for the middle class should be paid for by tax increases on taxpayers with the highest incomes. Under the original payroll tax credit plan, only one per

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[3] McIntyre, Robert S., "Tax Inequality Caused Our Ballooning Budget Deficit," *Challenge Magazine of Economic Affairs*, November/December 1991.

[4] For comparison of the President's $500 exemption and the $800 tax credit proposal, see Appendix II.

cent of taxpayers would pay higher taxes. This affluent group would face a modest increase to 35% in the marginal tax rate on taxable incomes in excess of $145,000 for joint filers, or $85,000 for individuals. In addition, the 30,000 taxpayers with taxable incomes above $1 million would pay a 10% surtax on the portion of their income that exceeds $1 million. The original per child tax credit plan differs in its details, but it too would be paid for by raising taxes on the well-to-do. The per child tax credit plan would raise taxes for an estimated six million taxpayers in the top 10% of the income distribution.

Though we do not have precise estimates, a 38% top bracket, coupled with a surtax on the highly affluent of somewhat more than 10%, and a modest increase in the Alternative Minimum Tax (AMT), would go a long way toward providing combined payroll tax credit-per child tax credit middle class tax relief. At 38%, the top bracket would be little more than half what it was in 1977.

The benefits of these middle class tax cuts would be widely spread. Under the payroll tax credit plan, taxes would be cut for an estimated 80% of taxpayers. Joint taxpayers having annual earnings between $26,000 and about $150,000 would receive the largest credits. The payroll tax credit plan provides relief to working taxpayers overburdened with payroll tax increases, in a manner which neither curtails contributions to the Social Security trust fund, nor gives employers an expensive and ill-deserved tax break. The refundable per child tax credit plan would provide 35 million families, some 135 million people, with the means to partially offset the consequences of prolonged federal abdication of responsibility for the welfare of the nation's most precious asset, its children.

In terms of fiscal impact, the original payroll tax credit plan would add to the deficit over the next two years, would be revenue-neutral over the next five years, and would generate an increase in federal revenues of about $10 billion per year over the long term. These fiscal impacts result from the fact that the tax credit for working families is temporary, while the tax increases on the top one per cent are not. The original per child tax credit plan would be revenue-neutral. These fiscal impacts are in sharp contrast to those of the Administration's proposals, which achieve fiscal balance only through "smoke and mirrors" accounting gimmicks and the diversion of resources needed for public investment.

CAPITAL GAINS

The AFL–CIO is strongly opposed to proposals to cut taxes on capital gains. We believe that it is unfair to tax the wages and salaries of working people at a higher rate than the profits made by the wealthy on their sales of stocks, bonds, real estate and other property. To do so would create a double standard that unfairly discriminates against one form of income—wages and salaries—in favor of unearned income in the form of capital-gains. By contrast, working men and women, who pay the lion's share of taxes must meet their income tax obligations in full every payday.

Cutting taxes on capital gains would benefit overwhelmingly the super-rich, those same taxpayers who have benefitted so extensively and so underservingly for the last dozen years. According to Joint Committee on Taxation estimates, more than two thirds of all the benefits would accrue to taxpayers with incomes in excess of $200,000. Members of this privileged group would receive tax cuts 83 times the size of those that would be realized by taxpayers with incomes below $50,000 who have capital gains at all.[5]

Cutting capital gains taxes would further undo the provision of the 1986 tax reform which equalized for a brief time the tax rate on ordinary income and capital gains. By doing so, the 1986 Act ended one of the most costly and unfair features of the tax structure and did much to eliminate the tax shelter industry which was so heavily based on schemes to convert ordinary income into preferentially taxed capital gains. Cutting the tax on capital gains would produce no benefit for the economy, apart perhaps from reviving the tax shelter industry. As economist Robert Eisner noted in recent testimony, such a tax cut might even depress the stock market, if successful investors rush to "cash in" their capital gains.

Claims that cutting taxes on capital gains would somehow increase federal tax revenues is a cynical affront to the intelligence of the American people, redolent of voodoo economics at its worst. In reality, it would cause a huge, permanent revenue drain, continuing a sorry legacy of pushing problems off onto the future for short term political gain. The evidence that a cut in capital gains taxes would sharply re-

[5] Esenwein, Gregg A., "Current Tax Cut Proposals: An Economic Analysis," *CRS Issue Brief—Major Planning Issue*, p.4.

duce revenues is overwhelming; we urge this Committee to review it carefully before being seduced by bogus estimates that it could not.[6]

HEALTH CARE

The AFL-CIO opposes the Administration's attempt to use the tax code to paper over its disgraceful failure to develop comprehensive, effective proposals to overhaul the nation's health care system.

Skyrocketing health care costs have placed a tremendous drag on the nation's economic growth, making employers who provide health care coverage less competitive at home and in international markets and forcing millions of Americans, who cannot meet the high cost of care, into the ranks of the uninsured.

In 1992, expenditures for health care are expected to consume 14 percent of Gross National Product (GNP) and exceed $800 billion. At the same time, 37 million Americans are uninsured and another 60 million have coverage that is inadequate to meet their needs. While economic barriers to health care coverage have put the nation behind many third world countries on measures of health status, such as infant mortality and morbidity rates, approximately $150 billion of what is spent on health care annually is going towards wasteful and inappropriate procedures.

The Administration has responded to these trends by proposing that low income families be given tax credits to help pay for the high cost of private insurance. In our view, changes in the tax code will have little impact on the broad, urgent problems in the health care system. No tax credit program will contain rising health care costs, which are expected to exceed $1.5 trillion by the end of the decade; nor will tax credits stop the costly and harmful delivery of unnecessary tests and procedures or reduce administrative costs, which consume 25 percent of every health care dollar.

No tax credit program will ensure that all Americans have access to health care coverage. It is a voluntary effort which may allow some uninsured families to receive coverage but, at the same time, provide strong incentives for employers to drop employment-related protection and reap a competitive advantage in the marketplace. Even if the original credit covered a significant amount of the insurance premium, the value of the credit will erode quickly with health care costs rising at double digit rates.

At present, less than 40 percent of families with incomes below the federal poverty line qualify for Medicaid. These are the individuals that the tax credits are designed to help. Unfortunately, the tax credit proposal is an ineffective means of compensating for the structural inequities in the current system. Subjecting poor families to the whims and unfair administrative practices of private insurers gives little piece of mind to those that have been locked out of the system that was established to protect them.

The time has passed for band-aid approaches to health care reform. Now is the time for comprehensive reform that would create a single national cost containment program, put a cap on the rate of increase in total health spending, contain fair and equitable financing, provide a core benefit package to which all Americans would be entitled, and require all employers to contribute fairly to the cost of care.

Providing for subsidies to offset health care contributions for low income families, ending the unfair pricing and administrative practices by private insurers, expanding consumer choice and encouraging the development of managed care should be part of a national reform strategy but cannot substitute for such a strategy. Recently, the Senate Labor and Human Resources Committee reported out comprehensive legislation that would address the problems of cost, access and quality. This body has a number of proposals before it that reflect our principles. We urge you to act deliberately and expeditiously to move legislation forward.

FLEXIBLE INDIVIDUAL RETIREMENT ACCOUNTS (FIRAS)

Proposals to further mortgage the nation's future by creating so-called "Flexible" IRAs have no place in any economic recovery program worthy of the name.

By allowing up-front contributions in after-tax dollars only, including rollovers from conventional IRAs, FIRAs would create the appearance of raising revenue temporarily. By allowing subsequent tax-free withdrawals of interest and principal, they would result in an enormous and growing hemorrhage of revenues for years to come. In conventional IRAs, investment earnings compound tax free, but income tax must be paid on those earnings when they are withdrawn from the account. Under the FIRA proposal, by contrast, investment earnings not only would compound tax free; no tax would be collected on those earnings even upon withdrawal. Thus, wages

[6] Gravelle, Jane G., *CRS Report for Congress*, 91-161 RCO, March 23, 1990.

would continue to be taxed, while dividends, interest and other investment earnings sheltered in a FIRA would never be taxed, even when they are withdrawn.

Few taxpayers could afford the up-front payment of income taxes on contributions that a FIRA would require. Those that could afford to do so would reap a substantial reduction in future taxes. The short run revenue gain would in a few years' time become a huge and growing revenue drain. One similar IRA proposal analyzed by the CBO would lose $8 billion in tax revenues per year, far more than the Administration estimates for its FIRA proposal.[7]

TAX CREDITS FOR HOME BUYERS

As the AFL-CIO testified before the House Banking Committee on January 29, Representative Gonzales' proposal for the Home Ownership trust is the right kind of help for first-time buyers, rather than the tax gimmick put forward by the President, that will cost the Treasury more than $5 billion over the next 5 years.

Representative Gonzales proposes that the Home Ownership Trust, authorized by the National Affordable Housing Act, but never funded, receive $500 million in additional funds for this year. This is a highly targeted program aimed at providing down payment assistance and interest rate buy down aid to perhaps 50,000 first time buyers who would otherwise have difficulty purchasing a home. The help would be targeted to moderate income families buying modest homes. It would be repayable to the Trust. Buyers would pay at least one percent down.

If in place now, it might be possible, for example, for a worker with a moderate income to buy up to a $125,000 home with a down payment of only $1,250, instead of a down payment of $6,000 or more. The homebuyer would receive $4,800 at time of settlement. This is preferable to the proposed $5,000 tax credit over two years, which would not be as highly targeted and would not be available at closing when the home buyer would need the aid.

CORPORATE TAXES

The AFL-CIO has serious reservations about the wisdom of cutting corporate income taxes, whether in the form of Administration proposals to create an Investment Tax Allowance (ITA), reduce the Alternative Minimum Tax (AMT), or by other means. Corporate income taxes today account for only 9% of federal revenues, compared with 23% in 1960 and 17% in 1970, and 13% in 1980. One of the goals of the 1986 tax reform legislation was to eliminate several distortions and loopholes such as the investment tax credit from the tax code. The "base broadening" that resulted from elimination of these loopholes was an explicit tradeoff for a reduction in tax rates, which in the case of the corporate income tax, were reduced from 46% to 34%. The AFL-CIO opposes tax breaks for corporations without offsetting increases in other corporate taxes sufficient to achieve revenue-neutrality within five years and for the longer term. Failure to do so would be a breech of faith with middle income working taxpayers, and could deprive the Treasury of billions of dollars in badly needed revenues.

Corporate tax cuts are slow acting and difficult to target. They are distinctly inferior, as a form of economic stimulus, to job creating expenditure programs, or to tax cuts for the middle class. As long as prospects for sales and production remain bleak, tax cuts for corporations will do little to stimulate the economy or create jobs.

If this committee nevertheless goes forward with the ITA proposal, we urge that it apply only to domestic goods and services, not imports. Failure to limit the ITA in this way will add to the trade deficit and further erode the industrial base. We also urge that other taxes on corporations be increased in subsequent years, sufficiently to make up for the ITA revenue loss.

TRADE POLICY AND TAA

Trade policy is also within this Committee's jurisdiction; it is an area where the Administration's proposals are of great concern to the AFL-CIO. We have set forth and will continue to set forth our detailed views on trade policy in other forums, but we wish to emphasize that long term revitalization of the nation's economy requires proper trade and industrial policies, which have not been forthcoming from this Administration or its predecessor. Jobs gained as a result of temporary economic stimulus will be of little lasting benefit if trade and industrial policy failures continue to permit erosion of the nation's industrial base longer term.

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[7] Greenstein, Robert "The Gingrich Tax Plan," *Center on Budget and Policy Priorities*, December 16, 1991.

This means trade agreements such as the proposed General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA) must be scrutinized carefully, not rubber stamped; the nation cannot afford any more such agreements unless it can be demonstrated unequivocally that they are in the interest of American workers and the American economy. It is also essential for the Congress to reenact the super 301 provision of U.S. trade law and pass the Trade Enhancement Act of 1992. Experience has shown that strong U.S. laws are needed to open foreign markets and reduce this country's trade deficit.

Furthermore, we urge this Committee to rescind tax provisions such as deferral and the foreign tax credit which presently encourage corporations to disinvest from America. We also urge you to address the problem of intercorporate pricing gimmicks of multinational corporations that allow them to escape taxation on their profits. We are particularly concerned with the low rate of taxes paid by Japanese multinational corporations.

Another important program within this Committee's jurisdiction is Trade Adjustment Assistance (TAA). TAA is the government's often-reaffirmed but never fulfilled commitment to help workers who are injured by trade. The Bush Administration and its predecessor have sought repeatedly to terminate TAA. While they have not succeeded, the program was gutted in 1981 and has remained cut back throughout a decade of massively higher trade deficits and worker dislocation.

The Administration's insistence on negotiating NAFTA and GATT agreements underscores the urgency of improving TAA. Whether such trade agreements are otherwise deserving of support or not, the workers who are injured by them need and should be entitled to compensation and assistance. Far too often in the past, workers have been let down by illusory programs which turned out to be an empty shell.

Unfortunately, the Bush Administration is dishing out this sort of shabby treatment of America's workers once again. While paying lip service to the need to help workers who will be injured by NAFTA, the Administration's new budget would eliminate TAA. Instead, as the AFL–CIO testified before this Committee on October 3, 1991, TAA requires major improvements in benefits, eligibility and funding if it is to provide meaningful help to workers injured by these and other proposed agreements. We urge this Committee to reject the Administration's heartless and cynical proposal to kill TAA, and to support comprehensive improvements in this vital program.

RISK OF A BIDDING WAR

While the original refundable payroll tax credit and refundable per child tax credit proposals have great merit, it is deeply troubling that the Administration's proposals may have set the stage for a tax cut bidding war, of the kind the nation is still paying for that occurred in 1981. The AFL–CIO opposes any outcome which amounts to a Christmas tree of tax breaks for business and the well-to-do, with or without the accompanying gift-wrap of modest tax cuts for middle income working families. We oppose even more strenuously any outcome which does not provide substantial and immediate economic stimulus to put an end to the recession, create jobs, and alleviate the suffering of the unemployed.

The President's program would create few jobs, and would do little to end the pain of this stubborn recession. The bulk of his program consists of a myriad of tax gimmicks that would provide little economic stimulus, but would seriously erode the tax base, primarily for the benefit of those who are already well-to-do.

Fairness requires adoption of refundable payroll and per-child tax credits for the middle class. Both fairness and the country's pressing revenue needs require that they be paid for by tax *increases* on the well-to-do. Corporations must also pay their fair share.

Economic recovery requires a comprehensive program of economic stimulus, help for the unemployed, and longer term policies of the kind we have urged in this testimony. Congress and the President should act immediately to develop and implement such a program to create jobs, repair the nation's crumbling infrastructure, and get this economy moving again.

Thank you for considering the views of the AFL–CIO on these important matters. Our views on several of the other revenue proposals put forward by the Administration, and by others, is set forth in the attached Appendix

APPENDIX I

The following are the views of the AFL–CIO on several additional revenue proposals put forward recently by the President and others.

TARGETED JOBS TAX CREDIT

The AFL-CIO opposes the proposal to extend the targeted jobs tax credit. This tax credit is an unwarranted wage subsidy to employers; it simply provides windfall profits to employers for hiring workers they have on their payrolls already.

ENTERPRISE ZONES

The AFL-CIO is opposed to Enterprise Zone proposals. These proposals will not create additional jobs or help to revitalize depressed areas. Rather, they will encourage the reshuffling of existing jobs from place to place, and heighten destructive inter- and intra-state competition for industry.

The recent history of enterprise zones set up under various state programs includes numerous instances where existing firms have relocated into zone areas, contributing nothing to net job creation, but nevertheless involving the expenditure of public funds.[8] It is difficult to determine whether businesses have set up, expanded, or relocated in enterprise zones due to the availability of tax subsidies or due to other factors, such as nearness to markets and adequate public facilities.

Eliminating capital gains for property located in a zone would benefit owners of older businesses, not new industry and even then, only when they sell out. The expensing of contributions to capital proposal also is a measure that would be most helpful to highly profitable businesses which need rapid write-offs to offset other incomes, rather than newly started businesses.

The proposed refundable tax credit for "qualified" employees would result in an inequitable tax situation among workers depending upon where they work. In many distressed areas, existing and potential employment would be outside the zone, and workers with the same income would not receive the credit. Thus, residents of the zone would not receive the credit if they worked elsewhere, while nonresidents might. Further, though it is an improvement over the existing targeted jobs tax credit which goes to the employer not the employee, we suspect that employers would use the credit as an excuse to pay lower wages.

INVESTMENT TAX CREDIT

We are not unmindful of the tremendous popularity in the Congress of proposals to restore some form of investment tax credit, but we urge this Committee to review carefully the overwhelming evidence that the investment tax credit is slow-acting, difficult to target, and extremely costly in terms of revenues lost as compared with economic stimulus produced.[9]

If the Committee nevertheless goes forward with an investment tax credit proposal, we urge that it be temporary rather than permanent; that it be targeted to those industries which will use it most effectively and are in greatest need, and that the credit apply only to domestic goods and services, not imports. Failure to limit the credit to domestic goods and services will add to the nation's trade deficit and enormous external debt, and will further undermine the industrial base. Furthermore, we urge that the revenues lost as a result of any temporary investment tax credit be made up over the next five years, by means of an offsetting increase in the corporate income tax rate.

ALTERNATIVE MINIMUM TAX (AMT)

The AFL-CIO opposes the proposal to scale back the corporate AMT with regard to depreciation. The AMT is essential to assure that corporations pay their fair share of taxes. The AMT should be strengthened, not weakened as the Administration proposes.

"PASSIVE LOSS" REAL ESTATE TAX BREAKS

We oppose restoration of so-called "passive loss" real estate tax breaks. Phasing out these tax breaks was sound tax policy when it was adopted in 1986; there is no valid reason to reverse course now. They distort economic activity, and are of benefit almost exclusively to the very wealthy. The only stimulus they would provide is to lawyers and accountants employed in the tax shelter industry.

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[8] *Enterprise Zones, Lessons from the Maryland experience.* GAO Report to Congressional Requesters, December 1988. Publication number GAO/PEMD-89-2.

[9] Gravelle, Jane G. and Kiefer, Donald W. "The Investment Tax Credit: An Analytical Overview," *Congressional Research Service Report No. 79-77 E,* March 6, 1979.

INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

The AFL–CIO opposes proposals to restore full IRA tax breaks to upper income taxpayers. The 1986 tax reform did not limit IRA tax breaks for the vast majority of taxpayers. Breaks were eliminated only for taxpayers with adjusted gross incomes above $50,000 (joint filers) who are not covered by employer-sponsored retirement plans. According to a recent Joint Committee on Taxation study, only 18% of taxpayers fell into this category in 1991; 73% of all taxpayers were still eligible to make fully deductible contributions to an IRA, while another 9% with adjusted gross incomes between $40,000 and $50,000 could still make partially deductible contributions.[10] The well-to-do would therefore be virtually the sole beneficiaries of restoring full deductibility of IRA contributions. It is estimated that 95% of the benefits from restoration of full deductibility would accrue to the richest 20% of taxpayers; nearly one third of the benefits would accrue to the richest 5%.

We see merit in allowing penalty-free loans from IRA accounts, to finance the purchase of a primary residence, and to pay for educational and extraordinary medical expenses, under rules similar to those which currently apply to loans from 401–K plans. The Administration's proposal to allow penalty-free withdrawals without requiring repayment goes too far; it would undermine the ostensible purpose of IRAs, which is to provide a vehicle to save for retirement.

TAX EXEMPTION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE AND GROUP LEGAL SERVICES

Proposals to extend for six months the existing tax exemption for employer-provided educational assistance and group legal services do not go far enough. The AFL–CIO strongly supports making permanent the extension of these tax exemptions. Employer provided educational assistance (Sec. 127) allows a worker to exclude from taxable income certain amounts paid by their employer for the purpose of educational assistance. Many workers use this assistance to improve their skills.

Group Legal Services (Sec. 120) should also be extended permanently. However, the Committee should consider increasing the annual premium in order to account for increases in the cost of providing this necessary employee benefit.

PENSION BENEFIT GUARANTEE CORPORATION

The AFL–CIO has long supported measures to bolster the financial stability and growth of the Pension Benefit Guaranty Corporation (PBGC). However, we oppose proposals contained in the President's budget that are aimed at "reforming" the PBGC, as they pose serious problems for the long-term pension and even health benefit security of workers.

INCREASE EMPLOYEE CONTRIBUTIONS TO CSRS

The proposed increase of 2% in federal employee contributions to their old pension plan is a break in faith to these workers who were told that the old system would be maintained. A basic element of that system was a 7% employee contribution, and a federal government share to provide the agreed upon benefits. Any short-fall in the trust fund, if there is one, is due to past failure of the federal government to pay into the fund.

PROHIBIT DOUBLE DIPPING BY THRIFTS RECEIVING FEDERAL ASSISTANCE

The proposal to prohibit "double dipping" by thrift institutions receiving federal assistance appears to have merit. The savings and loan debacle will cost taxpayers more than $500 billion, including interest. To add insult to injury, the resolution of failed thrift institutions has been mishandled almost every step of the way, thereby adding tremendously to the cost to taxpayers. To the extent that the proposal to prohibit "double dipping" represents a small, overdue step in the direction of limiting the hemorrhage it will have AFL–CIO support.

TAXATION OF CREDIT UNIONS

The AFL–CIO opposes the Administration's proposal to tax credit unions. Credit unions are depositor-owned and controlled co-operative associations, not privately-owned, profit-seeking corporations. It is therefore not appropriate to treat them for tax purposes in the same manner as commercial banks.

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[10] Greenstein, Robert "The Kindest Cut," *The American Prospect* Fall 1991.

Appendix II

	President's $500 Exemption Proposal Tax Credit Per Child	Refundable $800 Tax Credit Per Child
Paying No Income Taxes	0	(1)
In 15% Bracket	$75	$455
In 28% Bracket	140	156
In 31% Bracket	155	87
Cost to Treasury	$24 Billion over 5 years	0

[1] $800 less offset for interaction with Earned Income Tax Credit.

STATEMENT OF THE AMERICAN BAR ASSOCIATION

This statement is submitted by Peter L. Faber, Chair of the Section of Taxation of the American Bar Association, on behalf of the Association.

The Association recognizes that many forces are driving the consideration of significant tax legislation this year. The sluggish economy and continued high levels of unemployment, along with other factors, have generated numerous proposals intended to stimulate savings and investment, to "jump start" the economy, and to create jobs. Considerations relating to the progressivity of the Tax Code are simultaneously giving rise to another body of proposals, as well as raising concerns about the distributional effects of proposals intended to address the Nation's economic ills.

This Committee has the difficult task of weighing a number of diverse—and often competing—policies in evaluating proposals for legislative change. These policies include social policies, such as how progressive the federal tax system should be; economic policies, such as the appropriate balance between short-term economic goals and long-term economic goals; and policies that relate to using the income tax as a vehicle for raising needed revenues in a fair and efficient manner.

The ABA Tax Section does not claim expertise in matters of social or economic policy, nor have we been elected to make ultimate decisions that balance competing economic policy, social policy and tax policy concerns. Our primary expertise lies in the design of the tax laws pursuant to policies adopted by Congress, in the application of the Internal Revenue Code to business transactions and investments, and in the determination of the proper treatment of such activities on tax returns. Through our 25,000 members, we have broad experience with the extent to which corporations and individuals respond to opportunities to reduce taxes by arranging their activities to make use of tax incentives or preferences. We also have first-hand experience with the extent to which complexity and uncertainty in the tax law can have a chilling effect on business and investment activity.

My testimony today will not argue for or against any particular proposal based on our experience and expertise. The other policy considerations that must be taken into account by this Committee may well justify a different conclusion in a given instance than would be reached based on the limited tax policy considerations that I will address.

Our general position is that the Committee should proceed with great caution in adopting changes that run counter to the overall purposes and achievements of the Tax Reform Act of 1986. As you may recall the ABA strongly supported the fundamental objectives of the 1986 Act—broadening of the tax base and reduction in tax rates—in 1985 and 1986. We also testified before this Committee in February 1990, expressing our continued strong support for these principles. As tax practitioners, we continue to believe in the benefits to the tax system that have flowed from the 1986 Act.

While social and economic policy considerations may lead the Congress to reintroduce certain tax incentives in order to stimulate economic behavior that is determined to be desirable, we would urge the Committee to think back to the reasons for tax reform:

(1) *Fairness:* The preferences that had accumulated in the tax code before 1986 caused taxpayers with similar incomes to pay widely varying amounts of income tax. Individuals and corporations with substantial economic incomes were able to pay little or no tax by using these preferences. These factors fostered the perception that the tax system was unfair and undermined respect for the tax laws.

In addition to addressing these fairness concerns, tax reform's elimination of preferences and tax shelters had a significant impact on the effective progres-

sivity of the tax system. Even with lower nominal rates, the broadening of the tax base has caused many people with significant income to pay a higher effective tax rate on their income than they did before tax reform.

(2) *Efficiency or Neutrality:* Preferences distorted economic decisions, channeling funds into investments based on their tax results rather than their economic return. Tax shelters threatened the continued viability of our income tax system.

(3) *Simplicity or Administrability:* The existence of preferences and special rules forced taxpayers to determine whether they fit within the favored group or not, and the IRS had to make similar determinations as part of the audit process. Taxpayers understandably sought to fit their transactions within one of the favored categories, thus giving rise to transactional complexities and the artificial structuring of transactions and investments.

Many of the proposals that have been put forward to solve the Nation's economic ills are problematic when examined from the perspective of the goals of tax reform. Even though a proposal may seem harmless enough in isolation, it was the accumulation of such innocent provisions over time that made tax reform essential. We are concerned that the reintroduction of preferences—in the name of economic incentives—will lead to the very problems that tax reform was intended to solve. We are also concerned that the reintroduction of preferences will lead the country down the road of narrowing the tax base, a path that must inevitably also lead to higher rates. While we do not pretend to advise this Committee as to the proper setting of tax rates, we firmly believe that it is desirable to have a broad tax base together with rates as low as possible in light of the country's revenue needs.

The types of problems that concern us can be illustrated by many of the proposals that have been put forward. Without suggesting that any particular proposal raises these concerns more than others, let me give some examples of how several proposals can be viewed when one focuses on the goals of tax reform:

(1) *Fairness:* Fairness concerns are raised by such proposals as a targeted investment tax credit or allowance, which will result in taxpayers with similar income paying different amounts of tax. Taxpayers investing in equipment that falls outside the target will question the fairness of the provision, as will taxpayers in noncapital-intensive industries. Similar issues are raised if the credit or allowance is incremental since those who have made substantial recent investments will be ineligible for the benefit. A temporary credit or allowance would raise fairness issues for transition rules at both the beginning and the end of the period during which it is in effect. If incentives are adopted, they should be carefully crafted so as to encourage legitimate economic activity and not spawn a new generation of dubious tax shelters.

(2) *Efficiency or neutrality:* While an ITC could also be used as an example of a proposal that is contrary to the principle of tax neutrality, the enterprise zone proposals serve equally well. The proposals are specifically designed to induce certain types of investments, as opposed to tax reform's goal of letting market forces direct investments. Serious attention must be given to preventing enterprise zones from becoming the tax shelters of the 1990's.

(3) *Simplicity or Administrability:* An example of a proposal that raises complexity concerns is the proposal to reinstate a significant capital gains preference, which will reintroduce transactional complexity that was eliminated by the 1986 Act. As intended by the preference, taxpayers will seek to structure their activities, transactions and investments so as to receive favorable capital gains treatment. Attempting to convert ordinary income into capital gain will once again become a central feature of tax planning. The concept of limiting a favorable rate to only certain types of capital assets would introduce a dimension of complexity not present in prior law and would undoubtedly lead to efforts to convert nonqualifying gains into qualifying gains through various techniques. Multiple tiers of capital gains subject to different rates depending on the length of the taxpayer's holding period would place more pressure on the rules for determining holding periods and place a greater burden on taxpayers to keep track of the precise date on which an asset is acquired.

Having undoubtedly offended almost everyone who has put forth a proposal by pointing out what we perceive to be tax policy problems, let me hasten to reiterate that I do not mean to suggest that, all things considered, any of these proposals should be rejected. While they may raise important tax policy concerns, economic and social policy considerations may well outweigh these concerns. It is the unenviable task of this Committee to weigh all of these considerations in reaching its decision.

Before closing, I would like to make two final comments. First, I would like to pause for a moment on the subject of the complexity of our tax law. We believe that complexity has reached the point that a substantial number of taxpayers are unable or unwilling to comply with the tax law. Major contributors to the current level of complexity are the frequency of legislative change and, in a number of instances, a striving for conceptual purity that resists practical compromise with the real-world concern of administrability. This latter force is reflected in highly targeted proposals, the scope of which may also be constrained by revenue considerations. We hope that in drafting targeted provisions, including those that phase out as income levels increase, the Committee will be mindful of the complexity being engendered, particularly where the provision will affect large numbers of individuals. In this regard, we urge the Committee to measure the number of affected individuals not simply by counting those whose returns ultimately reflect application of the provision but by also counting those who must analyze whether they fall within the affected group or not.

Second, while we understand the desire to move quickly on a tax bill, we urge the Committee, to the extent possible, to release legislative language for study by groups such as ours before the legislation is agreed to. Chairman Rostenkowski is to be commended for following this procedure with respect to recent legislative proposals (such as the intangibles bill). Affording affected taxpayers and professional groups the opportunity to review legislative language in advance improves the quality of the legislation and goes a long way toward fostering faith in the fairness of the legislative process. The ABA Tax Section would welcome the opportunity to work with the staff in ironing out technical issues raised by legislative proposals. We volunteer our services and believe that as experienced practitioners and advisers we can be helpful to the process.

In sum, the ABA urges the Committee to be mindful of the achievement of tax reform and to proceed cautiously with provisions that may run counter to that achievement. Nonetheless, we recognize that many factors outside our area of expertise should properly be considered by the Committee in deciding whether a particular type of tax legislation is advisable.

February 20, 1992

Senator Lloyd Bentsen
Chairman
Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The American Dental Association respectfully requests that the Committee on Finance reinstate the tax deductibility of interest paid on student loans as part of a viable economic growth package for the middle class. Reinstating tax deductions for interest on student loans will foster two desirable goals in a fiscally responsible manner - providing sorely needed tax relief for the middle class and increasing accessibility to higher education.

The cost of higher education has increased 50% nationally in the last decade, while access to grants and scholarships has been restricted.[1] Such trends do not pose a problem for wealthy students or those who receive comprehensive, low-income grants. However, for the 90% of students who must finance their own education to some degree, the increased costs pose significant obstacles. In fact, the great majority of students are low or middle-class, and over 50% of them rely on federally-backed student loans as the primary means of financing their education.[2]

Dentists, newly graduated from school and desirous of establishing a practice, face the dual burdens of repaying exceptionally high student debts, while financing the capital outlays necessary to set up practice. In February 1990, Dr. Michael Crete, a dentist from Michigan, presented the situation of the average young dentist in testimony before Representative Rangel's Subcommittee on Select Revenue Measures. The average dental student graduates with $52,000 worth of debt from strictly educational costs.[3] An investment of approximately $90,000 is necessary to begin even a modest, one operatory practice. When weighed against the fact that a significant percentage of young dentists earn less than

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[1] Senator Bill Bradley (D-NJ), testimony before the House Committee on Education and Labor, February 6, 1992.

[2] Ibid.

[3] American Association of Dental Schools, "1991-92 Senior Survey" (Washington, D.C.: American Association of Dental Schools), 1992.

$20,000, a strong case is made that tax relief in the form of deductions for interest on student loans is necessary and equitable.[4]

Reinstating the deductibility of interest on student loans would lessen the burden on students, removing a disincentive to students considering a career in dentistry and making it more feasible for young dentists to practice in rural and low-income areas. Without legislation which makes dental education more affordable, young dentists will be forced to seek only the most remunerative practice situations to support their obligations. The existing problem of inadequate dental services in rural and urban low-income areas will worsen. Furthermore, the expense of a dental education contributes to the continuing decrease in the number of applications and the closing of several dental schools, creating a looming threat to even middle-income areas.

Restoration of the tax deductibility of interest paid on student loans would increase the opportunity for under-represented groups to pursue higher education. The current state of dental schools is of course critical to the future of the profession and the services it can render to society. The American Dental Association is committed to creating a diverse body of dental students to meet the oral health needs of all Americans. At present, fifteen percent of dental school students are black or Hispanic. One out of every three students is a woman.[5] This composition is not yet representative of the population at large, but it is improving through the efforts of the schools. However, the continued expansion of opportunity in this field is jeopardized by its high cost.

In light of the length and breadth of the problem, the American Dental Association supports full deductibility of interest paid on students loans. Such action would reduce the burden on the individual, reduce the default rate on student loans, and facilitate provision of dental care to all segments of society. Legislation addressing the financing of student loans would recognize the importance of higher education to the ability of a nation to compete globally. Access to science education is particularly important to the smooth functioning and advancement of a modern economy. For these and other reasons, legislation providing tax relief for educational loans has won bi-partisan support in both houses of Congress and was recently supported by the Administration in the President's State of the Union Address.

A further point supporting deductibility of interest on student loans is that a dental education is a requisite to the practice of dentistry. The cost of this education is an unavoidable business expense, yet loans to cover this cost are currently labelled consumer loans. The American Dental Association believes that this treatment of these loans is inappropriate, and could be corrected with the incorporation of full tax deductibility of interest paid on student loans in an economic growth package. Inclusion of such relief would aid dentists in providing quality oral health care to society now and in the future.

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[4] Bureau of Economic and Behavioral Research, "1991 Survey of Dental Practice" (Chicago: American Dental Association), 1991.

[5] The source for the demographic information in this section is the Council on Dental Education, "Annual Report on Dental Education, 1991-92 Academic Year" (Chicago: American Dental Association), 1992.

There is legislation before Congress which will assist in moving towards these goals. The American Dental Association endorses S.2160, sponsored by Senators Boren and Grassley, which would provide some degree of relief for all students. With passage of such a measure, loan burdens would be lightened by either a credit or a deduction, with the benefits being enjoyed by the government and society as well as the individual. Moreover, the targeting of the most extreme cases makes this a fiscally sound instrument. Relief as proposed in S.2160 is limited to needs-tested loans, and would be applicable to only 48 months of the life of the loan. The Joint Committee on Taxation reports that this selective interest deduction program could save 70% of the revenue that would be spent in a universal program.
This legislation will stimulate the American economy in both the short and long-term. Upon enactment, it will provide relief for middle class families and struggling students with almost no effect on government revenue. As a first step in making higher education more accessible, it works towards maintaining and increasing the education level of our work force. Reinstating the tax deductibility of interest on student loans is an investment in our future we cannot afford not to make and deserves inclusion in the growth package under consideration.

Please let me know if I may provide any further information on this subject. Thank you for your attention to this important matter.

Sincerely,

William E. Allen

William E. Allen, D.D.S.
Associate Executive Director

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

The American Farm Bureau Federation represents almost four million member families and is vitally concerned with the economic growth proposals that you are discussing today.

Whether the economy is weak, sort of weak, about to recover, in a recovery or about to go back into a slump is not the reason to change U.S. fiscal policy direction. The reason to change economic policy direction is that businesses and households are laboring under tremendous tax and regulatory burdens which mean that a lasting economic recovery will not be possible, federal revenues will continue to erode, spending will remain out of control and the deficit will worsen.

World events demand that the U.S. economy be stronger than ever. We should be showing by example to the former communist world that we really do support free enterprise, private property rights and the economic opportunity these institutions provide.

The facts of the matter are that households and businesses, which include all of Farm Bureau's membership, are under tremendous economic pressure from ever-growing federal spending and tax burdens and an explosive growth in federal regulations. Businesses and households need permanent relief if we are to return to a long period of economic growth and private sector opportunity.

During the last 12 years, there was one year of positive tax policy change--1981. The year of 1981 was followed by nine years of tax hikes and federal government growth. The economy grew for the rest of the 1980s because the 1981 tax changes favored the private sector, the Federal Reserve resolved to reduce inflation and all government regulations were under intense administrative review for their potential negative economic impact.

The demise of the 92-month economic recovery of the 1980s was assured when Congress passed the 1990 budget agreement with White House help to raise taxes. Prior to the budget agreement, federal domestic spending had been reduced to less than a 5 percent annual increase in FY 1989. Federal domestic spending increased over 12 percent in FY 1991. It will increase over 8 percent in FY 1992 and by over 7.5 percent for FY 1993-95 according to the budget agreement of 1990. These increases are unconscionable in light of the economic adjustments now going on throughout the private sector.

The current tax and regulatory burden on businesses and households must be reduced if Congress and the administration are ever to resolve the nation's fiscal problems. Without the prospects of a growing economy it will not be possible to bring federal spending under control, and federal revenues will continue to grow slowly as the downward spiral feeds on itself. During the 92-month economic expansion, the deficit was declining as a percent of the GNP because federal revenues rose with expanded economic activity and the rate of spending was growing more slowly than the GNP.

Congress must begin to do what businesses and households do each year--adapt its spending to a level of tax revenue which a growing economy can support without impairing future economic growth. Congress must also enact economic growth tax incentives that are long-term and provide certainty in the tax code.

We recognize that any tax legislation drafted by the Senate Finance Committee will contain components of many of the bills under review. It is not timely for Farm Bureau to endorse specific legislation, but we can offer our position which we believe will be beneficial to the economy and taxpayers.

Farm Bureau supports all fiscal policy alternatives that have the net impact of reducing the tax and regulatory burdens on businesses and households. Specifically, we support the following fundamental changes in economic policy:

- Adjust capital gains for inflation and cut the capital gains tax rate;
- Change depreciation schedules to allow quicker recovery of investments;
- Cut Social Security taxes, especially the burden on self-employed, and convert to a pay-as-we-go basis;
- Increase the personal exemption for income taxes to offset the negative impact of inflation over the 1948 to 1991 period and to keep pace with wage and salary increases due to productivity gains. This is one area where middle class families have been put further and further behind;
- Put a two-year moratorium on all federal regulations;
- Freeze all federal outlays, including entitlement outlays, for the coming year at the current year level;
- Pass a constitutional amendment to require Congress to operate on a balanced budget through spending control;
- Give the President line-item veto authority; and
- Reinstate a permanent investment tax credit.

These recommendations reflect the position of nearly four million member families who are directly affected by the decisions you will make within this Committee. Farm Bureau asks you to review these points and approve those that lie within its jurisdiction.

STATEMENT OF THE AMERICAN HOTEL & MOTEL ASSOCIATION

The American Hotel & Motel Association is a federation of state associations located in the 50 states, the U.S. Virgin Islands, Puerto Rico and the District of Columbia. Our membership consists of over 9,000 properties comprising more than 1.4 million rentable rooms. Included within our membership are properties from all major hotel chains as well as a large number of smaller independent properties.

As with many other industries, the lodging industry has suffered through an economically devastating year in 1991. The decline in business due to the recession in this country was exacerbated by the Mideast war and the fear of travelling which that engendered. Vacations for many Americans became a time to stay at home and take day trips, not time to travel far and utilize lodging facilities. With the recession causing decreased business, business travel naturally slackened, also.

Now, as 1992 dawns our economy is still struggling, as yet unsuccessfully, to get moving and growing again. Traditionally, recovery in the lodging industry trails business recovery generally; business travel and recreational travel are a reflection of confidence in the economy and a response to a healthy business climate. Due to this lagging behind the general economic recovery, the lodging industry anticipates 1992 to be another troubled year. If, as many predict, true recovery is under way by the second quarter of 1992, the lodging industry can reasonably expect its own recovery to be delayed until the end of 1992 or the beginning of 1993.

As an affected industry, we particularly appreciate the willingness of the Finance Committee to recognize the need to promote long-term economic growth and short-term fiscal stimulus to the economy and for taking steps to reach those goals at this time. We also understand that there is no clear blueprint for recovery and that competing interests will be offering contradictory suggestions to the committee. Despite the difficulties this will create, if economic growth remains the goal we are confident appropriate measures will be adopted. With that in mind, we offer the following suggestions.

We believe you should include in your tax package specific employer incentives to train and retain employees. Specifically we believe that the Targeted Jobs Tax Credit should be made a permanent part of our tax code. There has been a repetitive history of short term extensions and even a time of lapse and retroactive application over the history of TJTC. The tentative nature of this credit has limited its usefulness. As a permanent part of the tax code more employees could integrate utilization of TJTC into their Human Resources policies. The lodging industry is one of the major industries providing entry level jobs to a broad range of individuals in our society. A permanent TJTC would enhance our ability to continue this practice and increase the prospects of those individuals intended to be benefited by TJTC.

Similarly, we believe that some form of capital gains treatment must be returned to the tax code. We are aware that capital gains has been a polarizing political issue with different opinions as to who is helped and the revenue effect from capital gains. However, we believe that the return of capital gains to our tax code is an effective means of benefiting a large segment of our society and is a sign of confidence by the Congress that our citizens should invest in the business of this country and should be appropriately rewarded for taking risks attendent to such investment.

Likewise, we join in the concerns expressed by many elements of the real estate industry to address numerous existing problems. As you are likely aware, the lodging industry has substantial real estate holdings and has also been affected by the downturn in real estate. Revisiting items such as passive loss, among others, can also be expected to have a salutory effect on certain segments of our industry

There has been some attention given to a return in some form of an investment tax credit. However much of what we have read has been targeted to the manufacturing segment of our economy. We would note that before its repeal, investment tax credit had application in the lodging industry, typically considered part of the service sector of our economy. We believe it inappropriate to return ITC to only one segment of our economy ignoring completely the service sector. As deliberations continue on this item we request you to keep in mind the previous application of the ITC.

As consideration of tax legislation to help provide a spur to our economy goes on, the "pay as you go" philosophy of last year's budget agreement will inevitably complicate and bog down the process. We believe that a healthy economy with growing employment and thriving business will return to the federal government in tax dollars the cost of starting that process. To look to take from an industry by increasing a tax on the healthy portion of its business whether to benefit that industry or another will inevitably cause the attempt to spur our economy to fail. In many industries, but in particular in the lodging industry, the economic condition is fragile. Over the past decade, wave after wave of new costly regulations, other expenses and taxes have hit the lodging industry. From spiralling health care costs, through forced wage increases, the costs of complying with the Americans with Disabilities Act and the partial disallowance of business meals and entertainment, the lodging industry has been repeatedly battered.

For the lodging industry, and others, to participate in the economic recovery Congressional tax action must help, not hinder that recovery. We call on the Finance Committee to be mindful of the difficult circumstances which industries such as lodging find themselves in, and we pledge our cooperation in working with you to reach your goal of economic growth.

STATEMENT OF THE BEAR, STEARNS & CO. INC.

I am pleased to testify before the Senate Finance Committee on taxes and the economy.

As a general matter, the economy shows very few signs of recovery. The long-awaited and much-anticipated recovery is still a forecast, not a reality. Indeed, a number of signs suggest that the recession may be spreading from the two coasts into the Midwest, and possibly the South. Revisions to the fourth quarter data on GDP may produce a negative number from the meagre rise of 0.3% at a annual rate reported initially. Early reports for the winter quarter ending in March are mixed, but do not suggest more than a flat or zero-growth quarter, and they do not rule out a quarterly decline.

In these circumstances I strongly recommend that the Committee report out an expansionary tax-cutting policy. The public should be able to clearly discern a stimulative fiscal approach, which might move the economy towards a 4% real rate of recovery during the next few years, in line with the average growth rate during the eight prior post-World War II expansions.

Tax measures to reduce the cost of capital and labor should be clearly announced and quickly implemented. Lower tax-rate incentives to reward producers, savers and investors should be the centerpiece, and these incentives should be made permanent, not temporary. Effective dates should be retroactive to January 1st or February 1st 1992, to avoid the continuous postponement or deferral of economic decisions to invest or spend, a factor which may already be at work holding back economic recovery.

The Committee should not be hamstrung by near-term concerns over the budget deficit. Deficit estimates following the 1990 budget deal have been raised significantly. Just since mid-year 1991, the deficit projected for the five years ending 1996 has been raised by $480 billion. This extraordinary mishap is a function of the longer than expected period of stagnation and recession, itself a result of rising tax and regulatory cost burdens which have created significant obstacles to economic growth.

While I certainly agree with the goal of steady deficit reduction during the years ahead, I emphasize the view that this goal will never be achieved in the absence of a strong recovery in economic growth. Should fiscal policy decisions be taken to reincentivize work effort and capital formation, then a historically normal recovery rate of 4.2% real output growth over the next three years, and a 3.7% rate over the five-year period, would reduce the Federal budget deficit to negligible levels by 1996-1997.

But this will never be achieved if the restrictive and austere fiscal policy of recent years is continued. Instead, policy must shift to an expansionary mode. We will never tax, spend or regulate our way to a balanced budget. We can, however, grow our way toward budget balance, provided that proper economic incentives are put in place, along with spending restraint. In this sense I recommend that the Committee reject the timid advice given by many economic experts. This is a time for bold actions to get the economy moving and to expand its long-run potential to grow.

Economic Situation

While real output began to recover in the middle quarters of 1991, rising at a 1.4% annual rate, real GDP expanded at only a 0.3 percent annual rate in the fourth quarter. What's more, recent trends for a number of key indicators suggest that the economy may be again turning down, and the winter quarter ending in March could even register a modest decline. The most recent employment report for January revealed a surprising 102,000 reduction of private non-farm payrolls. Within this report, manufacturing jobs dropped by 51,000, marking the fifth consecutive monthly decline, totaling 204,000 lost jobs in this sector. Also, retail employment fell by 51,000 in January.

Overall, during the most recent three months payrolls have lost another 318,000 jobs after temporarily stabilizing over the prior three months. This latest declining

jobs trend has been accompanied by three consecutive monthly declines in industrial production. More than likely, January will bring a fourth decline. Moreover, the Purchasing Managers index has declined in each of the past four months, while the trend in durable goods orders has been down in each of the last three months.

Meanwhile, retail sales have dropped in four of the past five months, and excluding car sales this measure has lost ground for five straight months. The combination of declining recent trends in employment, production and sales raise serious questions as to whether there will be any recovery at all in the first half of 1992.

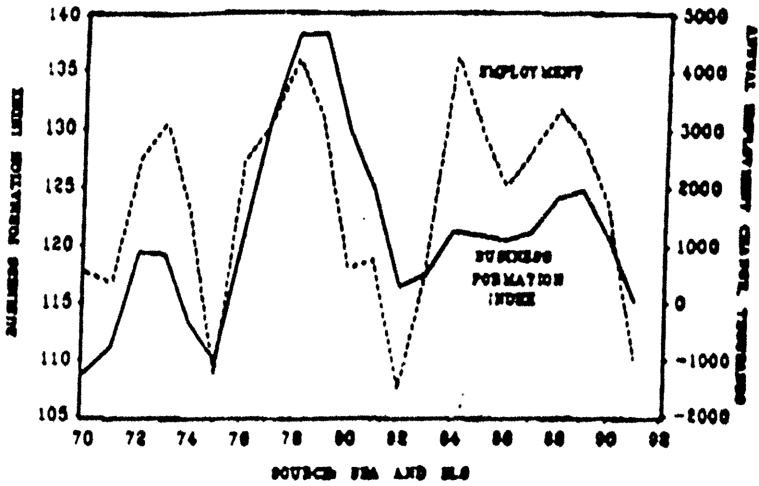
Economic indicators have slipped considerably in recent months.

Economic Indicator	Near-Term Peak	Percent Change Since Peak	Comments
Index of Net Business Formation	August	-1.4%	Down two of the last three months
Industrial Production	September	-0.6%	Down three straight months
NAPM Survey	September	-6.9 Percentage Points	Down four straight months
Durable Goods Orders (smoothed series)	September	-3.1%	Down three straight months.
Private Nonfarm Payrolls	September	-0.5%	Down four straight months.
Manufacturing Payrolls	August	-1.1%	Down five straight months.
Self-Employed Workers	September	-5.3%	Down three of the last four months.
Retail Sales	July	-1.3%	Down four of the last five months.
Retail Sales Ex-Autos	July	-1.7%	Down five straight months.
Leading Indicators Index	August	-0.6%	Down three of the last four months.
Coincident Indicators Index	July	-1.0%	Down three of the last five months.

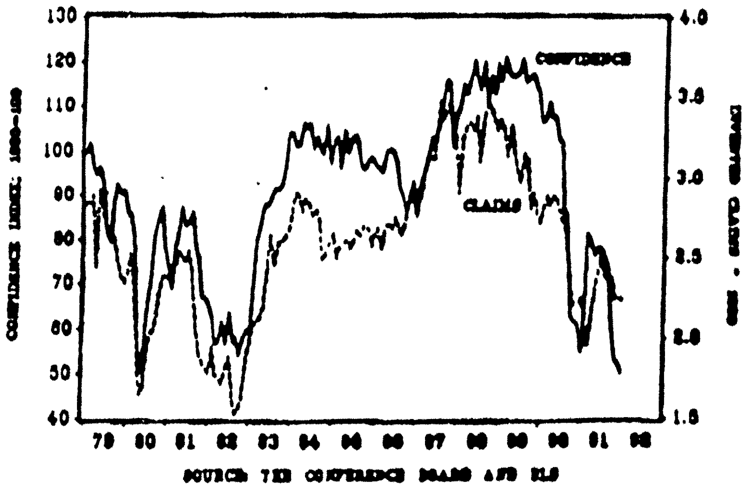
While reviewing these disappointing economic trends, I wish to draw special attention to two relationships. First is the linkage between new business formations and new jobs. Second is the linkage between rising unemployment claims and declining consumer confidence.

INDEX OF NET BUSINESS FORMATION & EMPLOYMENT

EMPLOYMENT = LEVEL CHANGE IN NONFARM PAYROLLS



CONSUMER CONFIDENCE & UNEMPLOYMENT CLAIMS



As a result of tax increase measures implemented in recent years, the cost of both labor and capital has been significantly raised while returns have been lowered. On the margin, many believe it no longer pays to work and invest. Perhaps this is best illustrated by the failure to reignite new business formation, which is the backbone of the entrepreneurial economy and one of the best indicators of risk-taking animal spirits. According to Dun & Bradstreet, new business incorporations peaked in the 1986-1988 period at around 66,000 per month, or 788,000 per year, moving up from around 41,000 per month or 488,000 per year in the early 1980s. However, through September 1991 this measure remains 20% below its prior peak.

The continuing weakness of new business formation is responsible for the lack of jobs growth. Since the cyclical jobs peak in June 1990, employment has declined by 1.68 million. This decline can be directly traced to the lack of new business creation. When the 1982-1990 expansion generated over 18 million new jobs, more than 90% of these new jobs were created by small businesses and new businesses. People forget that the largest American companies have been downsizing and restructuring for years; it was not this established corporate sector which created the job surge of the last decade.

Not only has overall employment growth stagnated, but minority employment appears to have come to a halt. Black unemployment, for example, which dropped from 21.2% in 1983 10.5% in the spring of 1990, stands currently at 13.7% through January 1992. For Hispanics, the unemployment rate dropped 15.7% in 1982 all the way to 6.7% in 1989, but during this recession has risen to 11.3%. From 1982 through 1987 Hispanic new business creation rose by 80.5%, and new businesses owned by blacks increased by 37.6%. While more recent data are not yet available, the disappointing unemployment rates in these minority areas suggest that minority entrepreneurship has sagged.

Zero Inflation

The most optimistic side of the economic outlook is the Fed's 1950s Bretton Woods-style monetary policy, which has significantly reduced inflation and interest rates over the past ten years, and has reintensified this effort over the past three years. The return to low inflation is important: there is no better foundation for economic growth than low inflation and its near cousin low interest rates. *It is the monetary equivalent of a tax cut.* Price stability

and strong monetary purchasing power are the keys to successful long-run economic performance. This is a greatly underrated factor in the economic outlook.

Under Greenspan's stewardship the theme of zero-inflation, or price stability, with a gold and commodity-backed dollar, is becoming more and more a reality. Despite nearly three years of discount and fed funds rate cuts, both gold and the CRB futures index remain steady. As a result, a forecast of a 2% CPI and no change in the PPI over the next twelve months is not out of the question.

In just the past year, three-month Treasury bills have declined from 6.3% to 3.8%, while ten-year Treasury note yields have eased from 8.2% to 7.3%. This explains the sharp rise of the stock market, which has increased real household net worth by an estimated $600 billion since 1990, and which is pointing to some improvement in business conditions during the year ahead.

The benefits of a zero-inflation monetary policy are enormous. Low inflation and declining interest rates are generating significantly reduced debt burdens. Mortgage interest savings alone could amount to $40 billion in 1992. Adding in potential interest expense reductions for non-financial businesses raises the total interest savings to the private sector to well over $50 billion in 1992. And while households are paying down their debt positions, rising financial asset prices are bolstering the shift to balance-sheet improvement. Moreover, price stability significantly enhances the purchasing power of household and business incomes.

On the other hand, the Fed's zero-inflation policy is forcing significant downsizing and cost-restructuring by all types of businesses and all levels of government. Since neither corporate revenues nor government tax revenues will be inflated by loose money, business and government will be forced to control costs and continue their efforts toward greater efficiency and productivity. Business products and government programs of dubious merit or efficiency must either be reduced or eliminated. By stripping away the veil of inflation, all US corporate and government operations will have to stand on their own merits.

Under a policy regime of price stability, the transition period to profitability in the private sector or budget balance in the public sector requires some painful adjustments, most recently symbolized in the restructuring announcements of IBM, GM, and Citicorp, as

well as downsizing in numerous state and local government entities. But the real story is not the transition, not the temporary recession, but the tremendous opportunities for long-term growth given very low financing rates, stronger purchasing power for incomes and lower break-even points for business profitability and global competitiveness. However, to fulfill these growth opportunities, fiscal policy must be redirected and reincentivized.

Fiscal Maladies

Regrettably, in recent years the nation's fiscal policy has become highly restrictive and the economy has suffered. Ideally a sound monetary policy aimed at zero inflation should be accompanied by a more relaxed fiscal policy designed to enlarge after-tax incentives to work and invest, to reduce regulatory and trade barriers and to enhance business entry, credit access and entrepreneurial opportunity. In other words, the right fiscal-monetary mix is tax cuts and tight money.

Instead, since the late 1980s, fiscal policy has generated regulatory and tax *increases*, along with tight money, all of which created a tightening noose around the economy's neck, leading to stagnation and recession. Since 1988, the real economy has grown by only 0.6% at an annual rate.

- Tax rates on personal income, capital investment, corporate income and real estate have increased in both nominal and real terms, accompanied by higher state, city and local tax burdens. On balance, the federal tax bills of 1986 and 1990 were significant economic depressants.

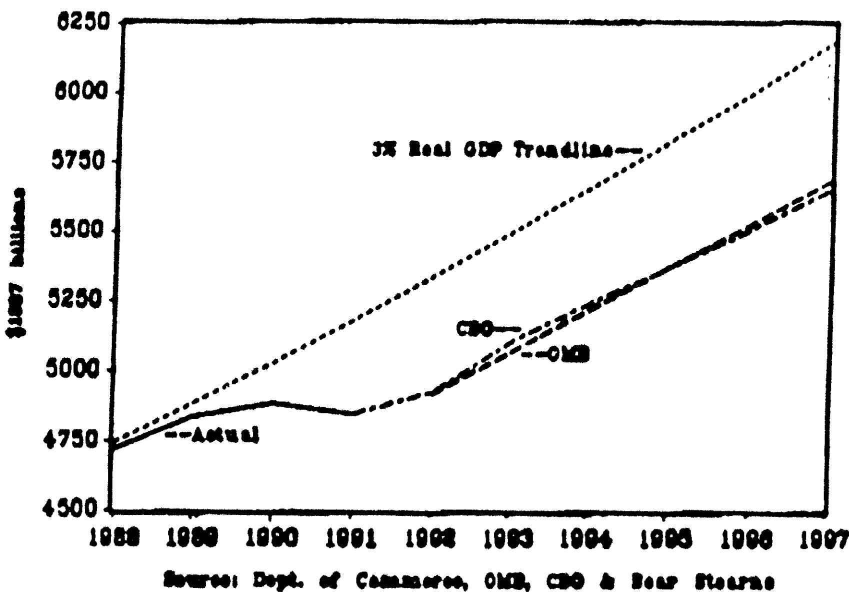
- At the same time, regulatory barriers for S&L's, commercial banks and the high-yield bond market have severely limited the normal flow and disintermediation of credit.

- Additionally, numerous environmental regulatory costs have similarly punished entrepreneurs and business operations.

- Large Federal spending increases are also inhibiting economic growth. New Office of Management and Budget (OMB) budget totals show that mandatory

spending in 1992 is projected to rise by a remarkable 22%, while total budget outlays are expected to rise by 11% over 1991. From 1988 to 1992, the budget outlay share of GDP is expected to increase from 22.1% to 25.1% of GDP. Many economists believe that budget spending is the truest measure of the economy's tax burden; whatever is spent must be financed through higher taxing, borrowing, inflating, or all three. This absorbs real resources from the private sector, and it provides strict limits on the economy's potential to grow

GROWTH DEFICITS



Source: Dept. of Commerce, OMB, CBO & Bear Stearns

Lost Potential

As a result of these policy errors, the potential of the economy to grow in the 1990s has been significantly limited. Consequently, without a redirection of fiscal policy, the actual level of real output in the next five years seems likely to remain below the 3% post-World War II path associated with long-term real economic growth. This will create a substantial growth deficit and by implication a jobs deficit. And it is a serious problem for policymakers.

The numbers here are startling. Both the Office of Management and Budget and the Congressional Budget Office (CBO) are forecasting subpar recovery rates. Compared to

the long run 3% post war growth trendline. OMB's implied estimate is an output loss of $498 billion (measured in 1987 dollars) from the trendline in 1997 and a cumulative $3.3 trillion loss over the 1992-97 period, assuming their 2.7% real GNP growth forecast.

For CBO the numbers are similar: a $532 billion loss in 1997 and a cumulative $3.3 trillion loss over the six year period using a 2.6% average growth path. No responsible economic policymaker should accept this subpar record. By my calculations, *the loss of jobs implied by CBO's and OMB's growth projections relative to the long-term trend baseline comes to a whopping 8 million.* It is precisely this point which must be immediately addressed in order to prevent a protracted period of U.S. economic stagnation.

ECONOMIC RECOVERY GROWTH

Trough year	Real GDP growth over the next: 3 years	4 years	5 years
1949	7.5	6.6	5.0
1954	3.0	2.1	2.8
1958	3.5	3.9	4.0
1961	4.9	5.1	5.3
1970	4.2	2.9	2.1
1975	4.9	4.2	3.3
1980	1.0	2.5	2.7
1982	4.8	4.3	4.2
Average	4.2	3.9	3.7

Note: GDP growth is calculated from the year in which the trough occurred.

New Goals: 4% Solution

But the Congress need not accept this subpar economic outlook. By reversing the tax and regulatory mistakes of recent years, the US economy could equal the 3.7% average five-year growth rate which followed the prior eight post-World War II recessions. New policies could raise GNP growth by as much as 1% per year compared to the OMB economic baseline, thus generating sufficient budgetary resources over the next five years to accommodate tax cuts and modest high priority investment-related spending increases, while still permitting steady deficit reduction.

Note that the fastest post-war recovery periods followed the recessions of 1949, 1961 and 1982. These were periods characterized by expansive fiscal policies generated through

significant tax reduction. Overall, for the eight recovery periods, real growth averaged 4.2% during the first three years of recovery.

This should serve as both a lesson and a goal. Congress should adopt a goal of at least 4% real economic growth for the next three recovery years. Moreover, Congress should seek to reduce the unemployment rate to the 4% zone. The passage of significant new tax incentives are key ingredients to the achievement of these goals.

ECONOMIC PROJECTIONS AND THE BUDGET DEFICIT
(Estimates of real growth are percentage change, Q4 over Q4)

	1993	1994	1995	1996	1997
1) Administration "Business As Usual" Real GDP	2.4%	2.5%	2.6%	2.5%	2.4%
2) Administration Deficit Estimate	$366.4	$239.2	$232.2	$231.9	$247.6
Memo item: a) Deposit Insurance	$76.7	($25.0)	($27.2)	($21.7)	($32.2)
b) Deficit Ex-Deposit Insurance	$289.7	$264.2	$259.4	$253.6	$279.8
c) As Percent of GDP	4.6%	4.0%	3.7%	3.4%	3.5%
3) Administration Policy GDP Add-On	0.6%	0.5%	0.4%	0.4%	0.4%
Memo item: a) Deficit Ex-Deposit Insurance	$276.2	$236.4	$219.3	$201.7	$214.0
b) As Percent of GDP	4.3%	3.5%	3.0%	2.6%	2.6%
4) Historical Post-WWII Recovery Path	4.1%	3.9%	3.2%	2.5%	3.7%
Memo item: a) Deficit Ex-Deposit Insurance	$228.5	$154.2	$129.4	$121.1	$94.9
b) As Percent of GDP	3.5%	2.2%	1.8%	1.6%	1.2%

Source: Office of Management and Budget & Bear Stearns

New Tax Policy

To achieve a 4% growth goal, I believe the Committee should develop an expansionary incentive-minded tax-cutting policy, including across-the-board tax-rate reductions for labor and capital. First, I recommend a *sizeable reduction in the capital gains tax, with full indexation to offset future inflation*. This is necessary to unlock existing assets and reliquify the economy by rechannelling the proceeds into new investments. At a time when commercial banks are not lending, the realization and reinvestment of capital gains may be one of the few available sources of credit in the period ahead.

The 45% exclusion of long-term capital gains, as proposed by the Bush Administration, is equivalent to a 15.4% tax-rate on capgains for taxpayers in the 28%

bracket. It is a good idea, but does not go far enough. The decision to extend capgains as a preference item under the provisions of the alternative minimum tax (AMT) could put the marginal tax-rate on capgains in a range of 24% to 30% for a large number of taxpayers, including middle-income taxpayers who take a large one-time capital gain. This would virtually negate the incentive effects of the proposal.

On the other hand, if the capgains exclusion is removed as an AMT preference item, then a significant reduction of capgains could unlock as much as $350 billion of capital gains realizations in 1992 and 1993 that could be rechannelled into new and more profitable investment. If only 10% to 20% of this is shifted into high-risk direct business investment, it would provide a much-needed $35 billion to $70 billion bank loan to the economy in a period when neither commercial banks, nor S&Ls, nor insurance companies, nor the junk bond market, nor Japan are extending new loans. The disincentive effects of AMT, however, could limit the increase in capital gains realizations to perhaps only $20 billion, which would amount to a negligible infusion of new capital of only $2 billion or $3 billion.

I would go further and recommend that for middle-income taxpayers in the 15% bracket, taxation of capital gains should be eliminated altogether. This would provide strong incentives to capital formation for middle-income taxpayers who make up the backbone of American businesses. It would also address the fairness issue. Also on the fairness issue, the capital gains tax should only be levied on real capital gains--i.e. gains after allowing for the effects of inflation. The current system of taxing nominal gains results in tax-rates on real gains that are far higher than the statutory rates and can sometimes exceed 100%. Similarly, income derived from interest and dividends should also be indexed in order to provide further incentives for saving and capital formation. Finally, we should be mindful that our current law actually provides for the triple-taxation of capital: once as corporate profits, second as dividend income, and third as a capital gain.

These reforms would raise after-tax rewards for capital investment and are essential to promote the risk-taking, innovation and new business creation necessary to raise the economy's long run potential to grow. With a proper incentive structure, those with capital will be willing to invest in new projects initiated by those without capital. Potential investors, innovators and entrepreneurs may come from the inner cities, or the research triangles, or Route 128, or Silicon Valley, or the Texas-Mexico border, but they will never realize their dreams unless they have access to new capital.

Capital costs would also be reduced by an *extension and enhancement of IRAs*. The Bush proposal to introduce flexible IRAs (FIRAs) is useful but does not go as far as the Bentsen Super IRA proposal, which would restore the universal availability of deductible IRAs for all savers regardless of their income level, as well as providing penalty-free access to IRA or employer-sponsored 410(k) plans for home purchase, education or devastating medical expenses. Improving the access to these kinds of tax-deferred or tax-exempt savings plans will encourage savings and further reduce the cost of capital.

In addition, for those new enterprises fortunate enough to have sufficient capital funding, the *cost of labor should be reduced* in order to enhance new hires, raise productivity and increase labor participation rates. Policy should aim to *reverse recent payroll tax hikes*; since the OASI taxable wage base is limited to $54,300, this would be a tax cut for the middle class. A direct payroll tax cut would do much to reduce the cost of labor, create new jobs and improve incentives, and would be a true across-the-board tax cut. By contrast, the proposal to increase the personal exemption for dependent children does not address these vital supply-side issues.

Finally, both new start-up and existing business firms would benefit from *accelerated depreciation of plant, equipment and structures where the depreciation is indexed for inflation*. Ideally, this reform would generate a neutral cost recovery system that would bring the present value of write-offs up to 100% of the cost for all assets and for all rates of inflation. An alternative method of lowering the cost of capital to equal the first year write-off would be a temporary investment tax credit (ITC), but capital cost reduction should be permanent, not temporary or ad hoc, and the ITC does not offset inflation, nor does it help new start-up firms with no net income. Either of these proposals, however, would be superior to the proposed 15% temporary additional first year depreciation allowance, which is roughly the equivalent of only a 1% ITC.

STATEMENT OF THE CALIFORNIA ASSOCIATION OF REALTORS

I. INTRODUCTION

As President of the California Association of REALTORS®, I am grateful to have the opportunity to present C.A.R.'s perspectives on President Bush's FY 93 budgetary and tax proposals to stimulate the housing and real estate industries and overall economic growth in the United States. C.A.R. is the trade association representing 135,000 real estate practitioners in California and our testimony today will focus on the real estate-related growth proposals recommended for approval by the president.

Before proceeding to our specific comments, however, C.A.R. would like to preface its testimony by expressing to the Finance Committee our appreciation for the timely manner in which the committee has commenced hearings on these economic growth proposals. California is a long way from Washington and part of our reason for submitting this testimony is to express to the members of the Finance Committee that economic conditions in our state are not good. Job losses in California have now surpassed those experienced in the 1980-1982 economic downturn.

The real estate industry in California, as in states elsewhere, has been hard hit by these job losses and the overall economic recession. Home sales levels which reached over 560,000 units in 1988 descended to just 420,000 units in 1991. Weakness in the commercial sector of the real estate market is also widespread, a result of overbuilding, the nationwide credit contraction and continuing repercussions from limitations of deductions enacted in the 1986 Tax Reform Act. Nonetheless, the fact is that, despite this weakness, real estate continues to comprise a substantial proportion of the nation's gross domestic product. And ultimately, California REALTORS® agree with President Bush's assertion that, as in past downturns, real estate can lead the nation out of this economic recession.

In general, C.A.R. is pleased with the real estate growth provisions proposed in the president's FY 93 budget, although we do believe that the refinements we suggest below could improve these proposals. We are hopeful that the Finance Committee, and Ways and Means Committee in the House, will approve a tax-based economic growth package as quickly as possible so that the nation can turn the corner on the road to economic health and so that the suffering and distress being felt by so many in the nation can begin to be alleviated. Again, we commend the Finance Committee for beginning work on a tax package in such a timely fashion.

II. FIRST-TIME HOMEBUYER TAX CREDIT

California REALTORS® strongly support President Bush's proposal to provide first-time homebuyers with a tax credit on the purchase of a principal residence. The proposed credit would equal 10 percent of the purchase price of the first home, up to a maximum of $5,000. Half of the credit would be applied to the taxpayer's tax liability for 1992 while the other half would be applied against 1993 taxes. The credit would be available for first-home purchases made after February 1, 1992 and before January 1, 1993 (although it appears households would have until June 30, 1993 to actually close their purchase, provided the sales contract for the home was signed by January 1).

C.A.R. economists estimate that the proposed tax credit would benefit 166,000 households in California; households who will purchase their first home in 1992. The credit would assist approximately 37,000 homebuyers in the Los Angeles region, 33,000 homebuyers in the San Francisco Bay Area, over 15,000 homebuyers in both the Orange County and San Diego regions, almost 13,000 buyers in the San Jose area and over 50,000 first-time buyers in the remainder of California.

In addition to those who will be aided by the proposed credit but who would have been able to purchase a home even in the absence of the credit, C.A.R. estimates that 15,000 additional renter households may take advantage of the tax credit and realize their dreams of homeownership. In other words, these are households who could not have qualified to purchase a home without the proposed tax credit. These additional buyers entering the California housing market would obviously benefit the real estate brokerage, homebuilding and lending industries, as well as the overall economy.

One shortcoming of the proposed tax credit is that it would not immediately put cash into the hands of hopeful homebuyers. The inability to accumulate the funds necessary to make a downpayment on their first purchase is a fundamental difficulty facing renter households. The proposed credit would instead reduce the future tax liability of households, providing them with funds in the second and third years of their purchase, but not at the onset. C.A.R. is hopeful that the lending industry will assist the president in his efforts to stimulate the real estate sector of the economy. This can be done by modifying their underwriting guidelines to recognize the fact that the tax credit will increase the net income of households, making them better able to afford the costs of homeownership.

Virtually all mortgage lenders use gross debt-to-income ratios to qualify borrowers, ratios which do not take into account federal tax obligations. C.A.R. would therefore recommend that Congress urge the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, through appropriate committee report or colloquy language, to relax their debt-to-income ratios for borrowers using the first-time buyer tax credit. Congress should also direct HUD and the DVA to recognize the first-time homebuyer tax credit when underwriting applicants for FHA-insured and VA-guaranteed mortgages. This would increase the affordability of housing for beneficiaries of the credit and ensure that the president's proposal provides the fullest possible benefit to the economy.

While C.A.R. supports the proposed tax credit for first-time home purchasers, the Association does have concerns with the credit recapture provisions recommended by the White House. The recapture would evidently apply to beneficiaries of the tax credit who sell their home within three years. C.A.R. opposes this recapture proposal. At a minimum, C.A.R. believes mandatory recapture provisions should be waived for first-time buyer households who are forced by factors outside of their control to sell their home within three years of purchasing it. While the recapture is waived for taxpayers who must sell because of death or divorce, there are other causes for exemption such as job loss, job change or transfer, or illness in the family. In other words, taxpayers should not be penalized by factors beyond their control which result in them having to sell their home within the proposed three year recapture period.

III. PENALTY-FREE IRA WITHDRAWALS FOR FIRST-TIME HOMEBUYERS

C.A.R. also supports penalty-free IRA withdrawals for first-time homebuyers. President Bush's proposal would permit first-time homebuyers to withdraw up to $10,000 from their flexible individual retirement accounts (FIRA), without incurring an early withdrawal penalty. A much broader, and therefore more effective IRA proposal, was made by Senator Bentsen in his "Super IRA" bill, S.612. This bill would allow first-time purchasers to make penalty-free withdrawals from the individual retirement accounts without any limit. In addition, their parents and grandparents could also make unlimited penalty-free IRA withdrawals in order to help them with the downpayment.

The provisions in Chairman Bentsen's "Super IRA" legislation (S. 612) are necessary to ensure that first-time homebuyers in high-cost states such as California are truly assisted by the proposed revisions to current IRA rules. In California, the median sales price of the typical home in November 1991 was $194,470. Accordingly, a $10,000 IRA withdrawal would amount to just 5.1 percent of the purchase price of the average home in California. However, in the U.S. as whole, where the November median sales price

was $97,800, a $10,000 IRA withdrawal would equate to 10.2 percent of the sales price of the typical home, an amount which would satisfy the downpayment requirements of most conventional lenders.

Most Californians are already denied access to low-downpayment FHA mortgages because of the FHA program's unrealistically low maximum loan amounts. While Californians would obviously benefit from being able to withdraw $10,000 from IRAs without having to pay a 10 percent penalty, they would not benefit to the same degree as households in lower-cost states. The proposed $10,000 cap should either be increased or eliminated so that Californians can use penalty-free IRA withdrawals to make the full, or nearly full, downpayment on their purchase. As with the FHA program, Californians should not be penalized by a federal program supposedly aimed at assisting all homebuyers which does not take into account the cost, and therefore the affordability, of housing in high-cost states such as California.

IV. MORTGAGE REVENUE BONDS/MORTGAGE CREDIT CERTIFICATES

California REALTORS® strongly support a permanent or long-term extension of the mortgage revenue bond and mortgage credit certificate programs. In his budget documents, President Bush proposes an extension of the MRB/MCC programs through the end of calendar year 1993.

The mortgage revenue bond and mortgage credit certificate programs, which are currently set to expire on June 30, 1992 have helped thousands of moderate-income households in California buy their first home. MRBs assist homebuyers of modest means by providing them with below-market rate mortgages. Typically, rates on MRB-funded home loans are one to two percentage points less than on conventional mortgages, an important savings which increases the affordability of housing in a state where less than a quarter of the households can afford to purchase the median priced home.

MCCs assist first-time purchasers by decreasing their federal income tax liability, thereby increasing their net income and the proportion of earnings which can be devoted to a house payment. MCCs entitle first-time homebuyers to a tax credit equal to 10 percent-to-50 percent of the interest they pay on their mortgage debt. Currently, 19 localities in California operate an MCC program.

The MRB and MCC programs have successfully helped thousands of first-time homebuyers in California surmount the state's severe housing affordability problem, Indeed, California Housing Finance Agency statistics show that almost 6,000 homes alone were purchased in 1991 through the agency's MRB-funded activities. This assistance should and must continue. We urge the Finance Committee to approve as part of its growth package a permanent or long-term extension of the mortgage revenue bond and mortgage credit certificate programs.

V. CAPITAL GAINS

C.A.R. is in favor of a reduction in the capital gains tax rate which would extend to real estate assets. For taxpayers in the 28 percent tax bracket, President Bush's proposal, when fully phased-in, would cut the top capital gains tax rate to 15.4 percent for assets held more than three years. Capital gains realized on assets held at least two years would be taxed at a top 19.6 percent rate while gains on assets held at least one year would be taxed at a maximum 23.8 percent rate. The president's capital gains tax reduction would apply to real estate and, in fact, would apply to all capital assets except collectibles.

While C.A.R. is supportive of the president's proposal to reduce capital gains taxes based on the holding period of capital assets, the Association has strong reservations over the fact that the White House has tied a cut in capital gains taxes to depreciation recapture.

Under the president's proposal, depreciation deductions taken on an asset qualifying for preferential capital gains tax treatment would be fully recaptured and taxed as ordinary income.

With respect to real estate, the depreciation recapture proposal would dilute, if not eliminate, any benefit of a lower capital gains tax rate and prejudice, from a tax standpoint, real property in comparison to other assets. This would inhibit the sale of real estate assets which would continue to be "locked-up" and any anticipated revenue enhancements would be foregone. C.A.R. urges the Congress to reduce the capital gains tax rate but maintain current law on recapture.

VI. PASSIVE LOSS RELIEF

California REALTORS® strongly believe the passive loss provisions of the tax code should be modified so that real estate entrepreneurs are no longer treated unfairly as compared to business professionals. Prior to the 1986 Tax Reform Act, losses from ownership and operation of rental real estate properties were fully deductible against other income of taxpayers. The 1986 Act changed the passive loss rules by only allowing losses from passive activities to be deducted against income from passive activities. Unfortunately, and unfairly from our point of view, real estate operators were singled out by defining rental real estate activity as a purely passive business activity. Thus, even if ownership, management and operation of real estate is a taxpayer's full-time business activity, these taxpayers are severely restricted in their ability to deduct losses incurred by these rental operations against other income.

As we have testified to Congress before, C.A.R. believes participants in rental real property operations were unfairly singled out by the passive loss restrictions of TRA. Accordingly, California REALTORS® are encouraged by the president's willingness to reopen the passive loss debate through his proposal to restore the deductibility of passive losses for material participants in real estate development activities. However, we cannot support the president's proposal at this time because it appears to be limited to developers and real estate syndicators and does not extend to all active participants in rental real estate activities.

Passive loss relief will not be effective if it does not apply to all taxpayers who are active in the real estate business. Because the White House's passive loss proposal is so limited, C.A.R. would like to again go on record at this time as strongly supporting S. 1257 as an alternative to the White House proposal. We believe S. 1257 should be approved as a stand-alone bill or that the exact language of S. 1257 should be included in the final growth package approved by the Finance Committee.

The widely supported S. 1257, the companion measure to House bill HR 1414, would correct the inequity to real estate professionals which was caused by the passive loss limitations. Under S. 1257, rental real estate operators who spend 50 percent of their time or a minimum of 500 hours per year on their rental operations would be able to fully deduct passive losses from their rental activities from other income. S. 1257 has garnered 43 cosponsors in the Senate, while 324 House members have cosponsored HR 1414. This means that almost 70 percent of the U.S. Congress is on record as supporting relief from the passive loss restrictions for taxpayers engaged in real estate rental activities. This legislation should be enacted, if not alone, then as a key provision of any economic growth package approved by the Congress this year.

VII. CONCLUSION

The California Association of REALTORS® appreciates the opportunity to testify on these important tax and growth issues now before the Finance Committee. C.A.R. wishes the Finance Committee success in devising a fiscally responsible economic growth package, a key portion of which will increase real estate activity in the nation and help the economy out of the recession. If you have any questions concerning our testimony or if C.A.R. can provide the committee with any further information, please do not hesitate to contact Leslie Appleton-Young, C.A.R.'s Vice-President of Research and Economics, at (213) 739-8325. Thank you.

STATEMENT OF THE COALITION OF INDEPENDENT CASUALTY COMPANIES OF AMERICA

I. INTRODUCTION

The Coalition of Independent Casualty Companies of America ("CICCA") is an association of small property and casualty insurance companies incorporated in the District of Columbia. It has members located in over 35 states and the District of Columbia. CICCA commends Chairman Bentsen for holding hearings concerning the U.S. economy and economic growth.

CICCA and its members are concerned with the effect of the Tax Reform Act of 1986 on small property and casualty insurance companies, particularly as compared with the treatment afforded small life insurance companies. In particular, CICCA and its members are concerned that a failure to address these problems in the near future will make it difficult, if not impossible, for small property and casualty companies to assist, as they historically have, with the next property and casualty insurance availability crisis. If this crisis occurs just as the Country is pulling itself out of the current economic downturn, the consequences could be highly negative.

This statement will contrast the tax treatment of small life insurance companies and small property and casualty insurance companies and the context in which such different treatment arose. It will highlight the impact of these provisions on small, growing property and casualty companies, indicating that the consequence is to produce dramatically high effective tax rates (frequently in excess of 100 percent) for such companies as compared with the statutory income they must report to their state regulators for solvency analysis and other purposes. It will suggest that the failure to address these problems could have highly negative effects on the U.S. economy if the next property and casualty availability crisis occurs just as the economy is beginning to recover. Since there is no policy reason justifying the less favorable tax treatment of small property and casualty companies in comparison to small life insurance companies, and because significant negative effects for the U.S. economy could occur under the current situation, CICCA recommends that small property and casualty companies be allowed a small company deduction like that which applies to small life insurance companies. This would be accomplished by enacting S. 1314, the "Small Property and Casualty Insurance Company Equity Act of 1991," originally introduced by Senator Boren.

II. CURRENT LAW

A. Property and Casualty Insurance Companies.

Property and casualty insurance companies pay income tax on their taxable income at the rates prescribed by section 11 of the Internal Revenue Code of 1986 (the "Code"). Code Sec. 831. The taxable income of property and casualty insurance companies is computed under the rules provided in part II of subpart L of the Code, which partially take into account the need for property and casualty insurance companies to maintain loss reserves and the other special circumstances that affect property and casualty insurance companies. Notwithstanding these provisions, it is very difficult for small property and casualty companies to grow as a result of surplus requirements restricting the amount of premiums which may be written and the inherently risky business in which they are engaged. In addition, an unusual loss occurrence, e.g., an earthquake, is more likely to financially cripple a small property and casualty company than is the case for larger companies which have more flexibility in diversifying their risks. Small property and casualty companies, nevertheless, play a significant role in the property and casualty industry, providing competition for large companies and, in some cases, providing coverage where large

companies are either unable or unwilling to provide such coverage. Their role can be particularly critical when coverage shortages arise as in the middle 1980s.

A very limited class of small property and casualty companies are either exempted from tax by section 501(c)(15) of the Code (those property and casualty companies, generally, whose yearly premiums do not exceed $350,000) or can elect under section 832(b) of the Code to be taxed only on their taxable investment income (those property and casualty companies, generally, whose yearly premium income is between $350,000 and $1,200,000). Even if the election under section 832(b) is utilized, electing companies are required to compute under the regular method for purposes of computing their alternative minimum tax liability.

The above provisions were inserted in the Code by the Tax Reform Act of 1986, to replace several provisions that previously applied to small mutual property and casualty companies. As is indicated below, these limited provisions are not comparable to the small company provisions applicable to small life insurance companies, notwithstanding the fact that predicting losses for property and casualty insurance companies is more difficult than for life insurance companies which are able to rely upon actuarial tables and which are not subject to the greater risks and uncertainties associated with property and casualty coverage.

The Tax Reform Act of 1986 included a variety of other changes in the tax treatment of the property and casualty industry. These changes have resulted in a significant increase in the tax burden of small property and casualty insurance companies, making it especially difficult for them to attract and retain capital, particularly as compared with small life insurance companies.

B. CICCA Study Analyzing Effect of Current Law on Small Companies.

CICCA has commissioned a study to analyze the impact of the current law on property and casualty income tax provisions on small, growing property and casualty companies. While the results are preliminary, they indicate that there is a direct relationship between the rate of growth of these companies and the magnitude of the Federal income tax rate as compared with statutory income they must report to their state regulators for solvency analysis and other purposes. In most of the situations other than where there is no rate of growth, the effective tax rate frequently exceeds 100 percent and almost always exceeds 50 percent. In those situations where the effective rate exceeds 100 percent, one of the obvious direct consequences is that the capital and surplus of the company is declining notwithstanding the fact that the company has statutory income prior to the effects of Federal income tax. Set forth immediately below is a summary of the preliminary results of the study indicating the effective tax rates on statutory income for each of the growth scenarios examined by the study.

SUMMARY OF EFFECTIVE TAX RATE ON STATE STATUTORY INCOME AS A FUNCTION OF RATE OF PREMIUM GROWTH

[Tax Rate]

Tax Year	1	2	3	4	5
Rate of Premium Growth:					
0%	130%	86%	58%	45%	38%
10	130	89	64	53	47
25	130	92	70	64	56
50	130	98	80	73	70
100	130	105	Infinite	654	Infinite
200	130	93	374	87	104

The preliminary results of the study clearly demonstrate that the effective rate of tax as compared with state statutory income increases as the rate of premium growth increases. Moreover, in companies with moderate to significant rates of growth, the rate of tax as a percentage of statutory income exceeds 100 percent on a regular basis. The results are clearly supported by the actual situations which many CICCA member companies are facing.

The preliminary results of the study indicate that the current Federal income tax rules will make it highly unlikely that small property and casualty insurance companies will be able, or willing, to rapidly increase their capacity when the next insurance availability crisis occurs. Historically, small property and casualty insurance companies have increased their capacity in response to coverage shortages. If this does not occur in the next coverage crisis, the crisis could be far deeper than has ever been observed in the past. Thus, serious consideration should be given to

the enactment of pending Federal income tax legislation, H.R. 2768, which would extend to small property and casualty insurance companies the same treatment currently afforded to small life insurance companies. Enactment of H.R. 2768 would significantly address the extraordinarily high rates of tax compared with state statutory income currently facing small property and casualty insurance companies.

III. IMPLICATIONS OF THE CURRENT TAX STRUCTURE FOR THE NEXT PROPERTY AND CASUALTY INSURANCE AVAILABILITY CRISIS

Historically, the property and casualty insurance industry has always been cyclical in nature. During the period of losses, the total surplus of the industry contracts. The typical consequence of this phenomenon is that periods of availability shortages arise. What has occurred generally in the past is that small property and casualty insurance companies have responded to these availability shortages by increasing the amount of their capacity. This is typically done through either incorporation of new small property and casualty insurance companies, or through addition of capital to existing companies.

The CICCA study preliminarily indicates that the effective tax rate as compared with state statutory income increases as the rate of growth of a company rises. As a consequence, it will be extremely difficult in the next availability crisis to convince potential investors to contribute capital to new or existing small property and casualty insurance companies. The return on investment compared with other small potential uses of capital is unlikely to make investment in a property and casualty insurance company sufficiently attractive. As a consequence, it can be anticipated that under the current Federal income tax structure, the next property and casualty availability crisis is likely to be far more severe than that which has been experienced in the past.

IV. PENDING LEGISLATIVE PROPOSALS WHICH WOULD ADDRESS PROBLEMS IDENTIFIED BY THE STUDY

Under current Federal income tax rules, small life insurance companies, defined as those with less than $500 million of assets, are entitled to a special small company deduction. This provision was enacted as part of the 1984 legislation rewriting the tax rules applicable to life insurance companies. This provision was intended to assist small life insurance companies in competing and growing in the life insurance industry. The provision entitles such companies to a 60 percent exclusion from what would otherwise be taxable income up to $3 million of income. The exclusion phases out between $3 million of income and $15 million of income.

Legislation is currently pending in the U.S. Senate which would extend the small life insurance company provision to small property and casualty insurance companies. This legislation is S. 1314, the "Small Property and Casualty Insurance Company Equity Act of 1991." Similar legislation is pending in the House as H.R. 2768. Enactment of this legislation would significantly address the problems currently faced by small, growing property and casualty insurance companies by offsetting, at least partially, the high effective tax rate on statutory income currently faced under existing tax rules. Enactment of this legislation would serve to significantly reduce the negative incentives which exist to contribute capital to new or existing small property and casualty insurance companies. Moreover, enactment of these provisions would make it substantially more likely that small property and casualty insurance companies would be able to play a significant role in addressing the next availability crisis.

If the U.S. economy begins to recover, or is in a full blown recovery, when the next property and casualty availability crisis occurs, the current tax rules are likely to make it impossible for small property and casualty companies to respond to the crisis. The negative effect on such a recovery, and for the Country, could be severe. Enactment of H.R. 2768 will avert such an undesirable situation and should occur as part of any economic recovery package.

STATEMENT OF THE COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers submits this statement for inclusion in the record of the hearings held by the Committee on Finance on February 12, 13, 18 and 19 concerning economic growth and the Administration's budget proposals. The Committee of Annuity Insurers strongly opposes the Administration's proposal to tax the earnings of non-qualified deferred annuities prior to the time those earnings are received.

The Committee of Annuity Insurers is a coalition of 44 life insurance companies which account for more than half of the annuity premiums in the United States. The Committee was formed in 1981 to monitor legislative and regulatory issues affecting annuity issuers and their policyholders. A list of the members of the Committee is attached.

THE ADMINISTRATION'S PROPOSAL

We urge the Committee on Finance to reject the Administration's proposal. The proposal would dramatically and detrimentally alter the Federal income tax treatment of non-qualified deferred annuity contracts, with the result that few, if any, of these important savings products would be purchased. As explained below, there is no justification for the proposal; it is bad tax policy and bad economic policy.

The current tax treatment of deferred annuities is carefully tailored to accomplish the important objective of encouraging retirement savings. The premiums for a deferred annuity are paid in after-tax dollars, that is, such premiums are not deductible in determining taxable income. Furthermore, current tax law does not allow earnings credited under annuity contracts to escape tax—it only permits a deferral of tax. All earnings credited to the contract will be taxed at ordinary income tax rates when money is actually received by the policyholder.

Under the Administration's proposal, a deferred annuity policyholder would be taxed currently on the earnings credited to his or her annuity contract, i.e., the "inside build-up," even though the policyholder has not received the earnings either directly or constructively. Thus, under the proposal, the policyholder would be put in the position of paying a tax on income he or she effectively cannot receive, thereby incurring an ongoing negative cash flow (because of the tax imposed each year on the inside build-up) for the privilege of purchasing an annuity.

The Administration's proposal provides an "exception" which would continue the current tax treatment for certain annuity contracts with "substantial life contingencies." However, the exception is meaningless. Under the exception, deferral of tax would continue only if a policyholder irrevocably committed, when buying a contract, to receive only a stream of income payments over his or her lifetime, and if the contract required the policyholder to forfeit most of his or her investment upon either surrender of the contract or premature death. Specifically, the contract would not be allowed to guarantee (1) payments for longer than ⅓ of the policyholder's life expectancy at the time payments begin, or (2) an amount (such as a death benefit) greater than ⅓ of the policy's accumulated value. The proposal's exception would require people, as the price of deferring tax on the inside build-up, to take a gamble that might cost them up to ⅔ of their retirement savings. For example, assume that at age 65 a policyholder began receiving payments under an annuity that met the Administration's proposed requirements and that had a $30,000 value when payments began. If the policyholder died immediately thereafter, his or her heirs could receive only $10,000 of the policyholder's $30,000 retirement savings!

No deferred annuity contract sold today would meet the requirements of the proposal—and, in all likelihood, no purchaser would want to purchase such a contract. It is true that all deferred annuity contracts, including both those currently sold and those which would meet the proposal's exception, provide protection against outliving one's income. Contracts accomplish this by offering a life annuity payout option which guarantees a payment stream to annuitants for the remainder of their lives. However, to lessen the risk of forfeiting their investment in the event of premature death, most people who choose this option couple it with a minimum guarantee feature (e.g., a 10-year or 20-year certain payout).

The Administration's proposal would prohibit this desirable structure and, instead, would retain current tax treatment only where there is substantial risk of loss of the annuity value. The effect of the proposal would be to eliminate one of the best retirement products available to the American public, with a resulting decline in the level of long-term investment in the larger economy.

IMPACT OF PROPOSAL ON RETIREMENT SAVINGS

One of the greatest challenges faced by middle class people in the United States is achieving financial security for their retirement years. Today many people face, and fear, the prospect that their fixed incomes after retirement will not be sufficient to meet financial needs which may arise, including the often burdensome expenses associated with long-term illness. Many also question the stability and adequacy of Social Security to meet such needs. Moreover, for middle age individuals who are not covered by tax-qualified pension plans and who cannot at their stage in life effectively utilize IRAs for retirement savings, these concerns take on heightened meaning.

To deal with these challenges, many people today rely on deferred annuity contracts. Deferred annuities are widely used as savings vehicles by middle class people who are at or beyond middle age and who are planning for retirement. The flexibility offered by these contracts, together with the long-term nature of the investment provided, make them ideal for people looking to retire in the next 10 to 20 years and seeking to fund part or all of their retirement needs over that period.

Indeed, the flexibility offered by deferred annuities is of paramount importance in retirement planning, since it is difficult to know in advance exactly what needs will arise for any particular retiree. The typical deferred annuity offers a variety of payout options, but also may be surrendered if a policyholder needs to access his or her savings when an emergency arises, e.g., a serious illness giving rise to medical expenses. It was for this reason that in its 1990 report on long-term health care funding, the same Treasury Department that now proposes to destroy the viability of deferred annuities urged their use as a means of savings to provide for long-term care needs. Further, the payout options available under a deferred annuity permit the selection of a payment method, including guarantees, offering the best overall protection for the policyholder and his or her spouse.

For the millions of Americans who are not covered, or not covered adequately, by qualified pension plans, the availability of deferred annuities is crucial. Although qualified plans have much greater tax incentives associated with them, since payments into such plans are either deductible or, if paid by an employer, excludable, people who have no access to such plans can today use the deferred annuity to help them achieve suitable retirement income objectives. In addition, the deferred annuity is available to those who need to supplement their retirement savings as, for example, in the common case where the employer's qualified plan is not adequate to meet a retiree's reasonable projected income needs. Hence, for a sizable group of people, the deferred annuity provides basic retirement savings, quite apart from providing a flexible means for meeting retirement needs.

The Administration's proposal, however, would prohibit such flexibility and would, instead, mandate commitment to a life annuity payout (with the accompanying risk of forfeiture on early death) at the inception of a contract, many years (sometimes even decades) before the payout is to commence. The proposal would arbitrarily cut off use of one's retirement savings to fund emergency needs, such as the often great cost of long-term nursing home care necessary in old age. Moreover, the proposal would effectively prevent policyholders from passing along retirement savings at death to a surviving spouse or other beneficiary dependent on the policyholder.

The reasons advanced by the Administration in support of its proposal are specious. The premise of the Administration's proposal is that deferred annuities are similar to other investments where income is taxed currently, and thus, the earnings under deferred annuities should also be taxed currently. However, this premise is incorrect. During the past decade, Congress has carefully crafted (in four tax enactments since 1982) a variety of restrictions on annuities in order to ensure that such contracts are utilized for *long-term investment* and *retirement* purposes (thus distinguishing deferred annuities from investments where earnings are currently taxable).

As a result of these changes, if a policyholder makes a premature withdrawal from an annuity contract, the amount withdrawn is considered to come first from earnings which have accrued under the contract, until all such earnings have been taxed. In addition, with limited exceptions, a ten percent penalty tax is imposed on withdrawals from a deferred annuity that occur before the policyholder has reached age 59½. For these purposes, a loan against, or a pledge of, the annuity contract is treated as a taxable distribution. Furthermore, the tax law now requires that distributions must commence from a contract on the death of the policyholder (unless the contract is transferred to a surviving spouse), thus providing an outside limit on the deferral of tax on annuity earnings.

Moreover, the tax treatment of deferred annuities is broadly available to, and is broadly used by, the Nation's middle class. These individuals could, of course, invest in other assets offering a similar deferral of tax on accumulated earnings, e.g., unrealized gains in stock. Indeed, these alternative investments have substantial tax advantages in comparison to annuities, in that if the gain is not realized during the owner's lifetime, his or her heirs will receive a "step-up" in basis and the gain will never be taxed. However, deferred annuities are unique in that they offer necessary security for retirement savings unavailable in other investments.

Experience has shown that the numerous changes enacted in the past ensure, as Congress intended, that deferred annuities are used for their intended purpose—to provide for the long-term retirement needs of the American public. Adoption of the Administration's proposal would eliminate a finely honed part of the tax law which encourages retirement savings and efficiently prevents abuse.

IMPACT OF THE PROPOSAL ON INVESTMENT IN THE ECONOMY

Savings, particularly the kind of savings that results in long-term investment, plays a vital role in promoting strong economic growth. The importance of savings has been recognized by the Treasury Department, which has emphasized that "savings is the life-blood of the economy." Indeed, a clear objective of the Administration and Congress is to increase national savings.

Individuals are the largest single source of savings in the United States, and the savings dollars held in, and annually added to, deferred annuities represent a significant portion of the total savings of Americans, particularly their retirement savings. More importantly, deferred annuity savings dollars are invested by policyholders for long-term, retirement-oriented needs and are locked into satisfying those needs partly by the tax law itself (via the penalty tax on premature withdrawals) and partly by contract design. As a consequence, life insurers issuing deferred annuity contracts, with a view to the contracts' purposes as well as their own investment policies and restrictions, typically make longer-term investments.

In view of the foregoing, we must disagree with the Treasury Department speculation that the Administration's proposal will not affect the Nation's level of savings. As Dr. Martin Feldstein, chairman of the National Bureau of Economic Research and former chairman of the President's Council of Economic Advisors, told the American Insurance Association's annual conference last month:

> "[I]nsurance is a potentially very powerful vehicle for savings [and] for national capital formation . . . . But, insurance can only be fully effective in increasing our national savings rate if tax laws and other rules that discriminate now against savings through insurance are changed and if legislation is adopted to encourage savings . . . . Other countries are much more aggressive in using their tax laws to encourage the . . . use of life insurance as a vehicle for savings . . . . [T]he Japanese . . . combine insurance and savings even in the property insurance area . . . . I think insurance should play a central role in increasing our national savings rate."

Deferred annuities are insurance products that promote savings, and preserving the sensible tax treatment that now exists for deferred annuities can encourage more savings, as Dr. Feldstein has suggested. By severely reducing the attractiveness of deferred annuities, the Administration's proposal discourages savings (primarily middle class savings for retirement) and simultaneously discourages the long-term investing by life insurers made possible by annuity savings dollars. Such consequences surely should be avoided at any time, let alone when Congress wishes to spur economic recovery and growth.

CONCLUSION: THE PROPOSAL SHOULD BE REJECTED

We strongly urge the Committee on Finance to reject the Administration's proposal. The existing tax treatment of deferred annuities is grounded in sound policy. Middle class people should be allowed to fund efficiently and effectively for their retirement needs through the purchase of deferred annuities, as the tax law now allows but which the Administration's proposal would effectively prohibit. The Administration's proposal represents unsound tax policy and, even more importantly, unsound economic policy. As such, we respectfully urge the Committee to reject the Administration's proposal.

COMMITTEE OF ANNUITY INSURERS MEMBER COMPANIES

Aetna Life & Casualty Insurance Company, Hartford, CT; Allstate Life Insurance Company, Northbrook, IL; American General Corporation, Houston, TX; American International Group, Inc., Wilmington, DE; American Investors Life Insurance Company, Inc., Topeka, KS; Broad, Inc., Los Angeles, CA Capital Holding Corporation, Louisville, KY; Charter National Life Insurance Company, St. Louis, MO; Church Life Insurance Corporation, New York, NY; CIGNA Corporation, Philadelphia, PA; Confederation Life Insurance Company, Atlanta, GA; Conseco Insurance Companies, Carmel, IN and Amarillo, TX; Delta Life and Annuity, Memphis, TN; Equitable Life Assurance Society of the United States, New York, NY; Equitable of Iowa Companies, DesMoines, IA; F & G Life Insurance, Baltimore, MD; Fidelity Investments Life Insurance Company, Boston, MA; Great Northern Insured Annuity Corporation, Seattle, WA; Hartford Life Insurance Company, Hartford, CT; The Holden Group, Los Angeles, CA; IDS Life Insurance Company, Minneapolis, MN; Integrity Life Insurance Company, New York, NY; Jackson National Life Insurance Company, Lansing, MI; John Alden Life Insurance Company, Miami, FL; John Hancock Mutual Life In-

surance Company, Boston, MA; Kemper Investors Life Insurance Companies, Chicago, IL; Keyport Life Insurance Company, Boston, MA; Life Insurance Company of the Southwest, Dallas, TX; Life Insurance Company of Virginia, Richmond, VA; Lincoln National Corporation, Fort Wayne, IN; Manufacturers Life Insurance Company, Toronto, Canada; Merrill Lynch Life Insurance Company, Princeton, NJ; Metropolitan Life Insurance Company, New York, NY; Monarch Financial Services Inc., Holyoke, MA; Mutual of Omaha Companies, Omaha, NE; Nationwide Life Insurance Companies, Columbus, OH; New England Mutual Life Insurance Company, Boston, MA; New York Life Insurance Company, New York, NY; North American Security Life Insurance Company, Boston, MA; Protective Life Insurance Company, Birmingham, AL; Reliance Life Companies, Philadelphia, PA; Sun Life of Canada, Wellesley Hills, MA; Travelers Insurance Companies, Hartford, CT; Xerox Financial Services Life Insurance Company, Oakbrook, IL.

STATEMENT OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT

TAX RELIEF AND ECONOMIC GROWTH

Mr. Chairman, my name is Dean Phypers and I am Chairman of the Research and Policy Committee of the Committee for Economic Development, non-partisan organization of 250 of the nation's top business and academic leaders. I will be brief. A detailed statement of CED's position is contained in our recent program statement, Politics, Tax Cuts and the Peace Dividend[1], which I would like to submit for the record.

I want to make three points today:

* First, the nation will be best served if you do not reduce taxes. Deficit reduction should remain our first priority in order to raise long-term growth. Any peace dividend therefore should be used to reduce the deficit.

* Second, neither the President's budget nor most visible Congressional fiscal plans recognize this priority. Instead, they emphasize quick-fix, temporary actions to deal with election year pressures.

* Third, if it is deemed necessary to address these political pressures, such actions should be consistent with our long-term objectives to the greatest extent possible.

Deficits, National Saving, Growth and Living Standards

Our first task is to go "back to basics" on economic growth. Rising living standards require higher productivity, which, in turn, requires more national saving and investment. Those objectives demand deficit reduction, not tax cuts. Much of the current policy discussion, which focuses on the recession, unemployment and weak demand, simply ignores this fundamental long-term imperative.

Please do not misunderstand me. I recognize the economic distress in the country. I also recognize that, especially in an election year, there is great political pressure to "fix it." However, the distress is principally due to structural imbalances, especially the accumulation of private and public debt during the fiscal binge of the 1980s. These imbalances would be made worse over the long term by tax reduction that raises present or future deficits. Now that we have a fiscal hangover, we should not take "the hair of the dog." We should forgo tax reduction. The recovery will come as household and business balance sheets are repaired with the assistance of monetary policy, but this will take some time.

Longer term, to raise American living standards, alleviate economic distress and reduce poverty, we need the additional resources that can come only from economic growth. Yet our fiscal policy has been consistently anti-growth for years, and now--as this Committee knows better than anyone--the resources are no longer there. The U.S. national saving rate has collapsed from about 8 percent of national income in the three decades prior to 1980 to about 2 percent at present, reflecting both larger public deficits and reduced private saving. Our domestic investment,

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[1] Committee for Economic Development, Politics, Tax Cuts and the Peace Dividend (New York: 1991)

temporarily sustained by massive imports of capital, is declining in turn as foreign borrowing becomes increasingly unavailable and unwise.

We--and here I include the leadership of government, business, labor and the media--have done a poor job of explaining to Americans what large budget deficits are doing to their economic prospects. Deficits seem an abstraction, unrelated to the real economic world, unrelated (unlike tax cuts) to better paychecks or profits. But they are not an abstraction, nor do they affect only our future. They are dragging down our growth and living standards today. One recent study estimates that the lower national saving rate in the 1980s has cut our productive capacity by 5-7%, and that this shortfall will grow to 10-15% by the year 2000.[2] This growth shortfall will cost the average family $4,000 to $6,000, not the monthly McDonald's meal provided by "tax relief." The tax cuts under discussion in Washington are inconsequential in comparison with the good jobs, good wages, good housing, good schools and good highways we will sacrifice if we continue this course. This is what budget policy is <u>really</u> doing to the American dream.

<u>Current Budget and Tax Proposals</u>

From the foregoing discussion, you will understand why I cannot enthusiastically support either the President's budget or many other fiscal proposals being discussed. They do not give priority to the long-term deficit reduction required for stronger economic growth.

I recognize that the President's budget, like the Chairman's earlier proposal and several other plans, are designed to be "revenue neutral" and adhere in rough fashion to the 1990 Budget Agreement. Nevertheless, they fail to address the long-term deficit problem adequately for several reasons:

* First, the long-term budget outlook is perhaps the worst we have ever faced, notwithstanding the savings from reduced defense spending. For the first time, long-term projected deficits are now rising rather than declining.

* Second, the pressures to break the Budget Agreement are very strong. Whatever the merits of particular adjustments, such an action would leave us adrift, without fiscal moorings, in a political gale.

* Third, the dangers of deficit expansion under the pressures of political competition to reduce taxes are grave. Memories of the 1981 bidding war should instruct us, but they may not suffice.

* Fourth, these pressures generate imprudent fiscal assumptions. The President proposes to pay for his immediate tax cuts with accounting changes and tax changes which raise revenues now but lose large revenues in the future. The Chairman's proposal assumes that a temporary middle-class tax cut will not be extended. Others assume tax cuts which "pay for themselves" or are financed by unrealistic spending reductions.

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[2] E.S. Harris and C. Steindel, "The Decline in U.S. Saving and Its Implications for Economic Growth," <u>Federal Reserve Bank of New York Quarterly Review</u> (Winter, 1991)

* Finally, we now seem to be trying desperately to snatch fiscal defeat from the jaws of victory. The Soviet collapse gives us an unexpected opportunity to transfer enormous resources from defense to capital formation. In this spirit, CED last June recommended that the entire peace dividend be devoted to deficit reduction.[3] Yet Congress is now arguing only about whether the peace dividend should be frittered away on tax cuts or on more domestic spending, and the President has invited Congress to pay for his tax cuts with the peace dividend if it so chooses. This would be a grave mistake. We should use the peace dividend only for deficit reduction. Tax cuts should be considered only when our children can afford them.

Damage Control in an Election Year

I fully recognize that recommendations to avoid tax reductions entirely may be unrealistic in the current environment. In this context, I urge that you follow two principles which would help protect national saving, investment and growth:

* First, any tax cuts should be paid for. The peace dividend should be husbanded for the future through deficit reduction. Any other approach would squander an opportunity to extricate ourselves from a terrible problem of our own creation.

* Second, any tax reductions or spending increases should produce productive public investments we would wish to make in a non-recession, non-election year. In this regard, CED particularly welcomes the President's attention, for instance, to research and development, Head Start, and math and science education. However, I strongly underline the word productive when attached to the words "public investments." I need not elaborate on the difference between productivity and pork.

Mr. Chairman, this concludes my statement. I thank you and the Committee for your patience in hearing advice that may seem unrealistic. But I do believe that someone should speak for the long-term public interest, and I have tried to do so.

* * *

[3] Committee for Economic Development, The Economy and National Defense: Adjusting to Military Cutbacks in the Post-Cold War Era (New York: 1991)

EQUITABLE RESOURCES ENERGY CO.,
Pittsburgh, PA, February 14, 1992.

Hon. LLOYD BENTSEN, *Chairman,*
Committee on Finance,
U.S. Senate, Washington, DC.

Dear Mr. Chairman: In connection with your hearings on the President's budget proposals, Equitable Resources wishes to submit for the record our recent testimony before the House Ways and Means Committee on needed energy legislation.

This testimony respectfully requests Congress' support for permanent extension of the Section 29 tax credit for the production of nonconventional natural gas from Devonian shale, coal seams, and tight formations. This energy source represents one-fourth of our remaining gas reserves in the lower 48 states. The credit expires this year.

As a developmental drilling incentive, the Section 29 tax credit is a needed complement to the Administration's exploratory drilling proposals. Much of the nonconventional gas is in known locations and is in proximity to existing pipelines and markets.

We believe the Section 29 tax credit is a cost effective incentive whose benefits more than pay for itself. It has worked very successfully since enacted by Congress in 1980 as part of our National Energy Policy. The credit has increased gas supplies, helped moderate the cost to consumers, and helped achieve our nation's air quality goals.

The Section 29 tax credit is one of the few incentives our industry has today to continue to drill gas wells. It is not a tax giveaway. The credit only applies if the well produces gas, and it phases out as prices exceed levels set by Congress. However, as explained in our testimony, many producers are unable to use the Section 29 credit due to certain unfair provisions of the alternative minimum tax (AMT).

Your support of this legislation is vitally needed to not only benefit consumers and the environment but also preserve jobs, increase capital investment, and improve the nation's energy trade balance.

I thank you for the opportunity to present these views and would be pleased to provide you with additional information.

Yours truly,

H.E. GARDNER, JR., *President*

Attachment.

STATEMENT OF EQUITABLE RESOURCES ENERGY COMPANY, BEFORE THE COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ON PERMANENT EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS, FEBRUARY 10, 1992

INTRODUCTION

Mr. Chairman, I am H. E. Gardner, Jr., president of Equitable Resources Energy Company (Equitable), a subsidiary of Equitable Resources, Inc. based in Pittsburgh, Pennsylvania. I want to thank you again for allowing Equitable the opportunity to present testimony on the importance of continuing the Section 29 tax credit for nonconventional natural gas produced from Devonian shales, coal seams, and tight formations.

Equitable is involved in all phases of the natural gas industry—distribution, transmission, gathering, and oil and gas exploration and production. Furthermore, Equitable is a leader in the development of nonconventional natural gas in the Appalachian Basin.

We last testified before the Committee at its March 7, 1990, hearing on Long-Term Strategies on the Environment. We then strongly urged Congress to extend the Section 29 credit as a cost-effective way to bolster production of a critical energy resource that can help achieve our Nation's air quality goals. Congress did extend the credit for two years, and I can state for the record today, that your action has been overwhelmingly successful. The supply of gas available to the American public has significantly increased, gas prices have moderated, and more gas is being used to benefit the environment.

SUMMARY OF POSITION

Equitable supports: (1) permanently extending the Section 29 credit for nonconventional fuels; (2) allowing taxpayers in an alternative minimum tax (AMT) situation to fully utilize the Section 29 credit by permitting the Section 29 credit to be credited against AMT; and (3) allowing taxpayers to carry forward any portion of the Section 29 credit that is otherwise lost under current law.

We believe an extension of the Section 29 tax credit is vital for the national interest for the following reasons:

- Nonconventional gas represents one-fourth of the Nation's remaining gas reserves in the lower 48 states according to the Department of Energy (Exhibit 1).
- The record shows that the Section 29 tax credit works. It has been a very cost-effective incentive since its inception in 1980 as part of the National Energy Strategy to reduce reliance on imported energy and produce more domestic gas.
- The Section 29 wells represent the only category showing an increase in new drilling. All others show a sharp decline. New drilling must occur to replace gas reserves.
- The increased supply of nonconventional gas has created greater competition in the marketplace with consumers benefitting from lower wellhead prices for gas.
- The increased supply provides a reliable and competitively priced fuel for improving the Nation's air quality.
- In the absence of market price incentives, the credit provides the needed incentive to overcome the higher development costs and lower production rates generally associated with nonconventional gas.

BACKGROUND

The Section 29 tax credit has applied to new nonconventional gas wells drilled since 1979. It was part of the Nation's response to the OPEC oil embargo and the gas shortage crises of the 1970's. Congress felt that development of our vast nonconventional gas resources should be stimulated through a production credit which would reduce dependence on imported energy.

Much of the Section 29 gas lies in well-known, shallower reservoirs near existing pipelines and markets. However, as the DOE's studies show (see Exhibit 1), the vast majority of these reserves cannot be produced economically without sufficient marketplace and/or tax incentives. At prices less than $3.00 per MMBtu, DOE estimates we lose 61% of the potential gas reserves in tight formations, 68% in shale, and 83% in coalbeds. Congress has designed the credit as sort of a backstop incentive to apply only when marketplace prices fall below pre-set thresholds, adjusted for inflation.

At lower prices, many nonconventional wells would otherwise become uneconomic due to the higher costs and lower well production rates involved. A nonconventional well typically requires expensive fracturing techniques and other technology to stimulate production to commercial levels. Its production life may run 30 years or more to deplete the recoverable gas reserve compared to 10 years for conventional wells. We find an Appalachian Basin coal seam gas well, for example, costs 10–20% more than a conventional well to drill, and its monthly well operating costs run 300–400% more.

EFFECTIVENESS OF THE SECTION 29 CREDIT

We believe the Section 29 credit is very cost effective. It is not a tax giveaway. It applies only after gas from specified formations is successfully found and sold into the marketplace. If the well is unsuccessful, all of the risk of drilling stays with the producer and no credit is available. Further, the credit applies only if market prices are too low to act as an incentive. The credit otherwise phases out as the price rises above the thresholds Congress has set.

We also believe the Section 29 credit is very supply effective. According to data compiled by the Energy Information Administration (EIA) on Exhibit 2, the number of new nonconventional wells being drilled as a percentage of all wells rose from 6.7% in 1980 to 18.3% in 1987, while the amount of nonconventional production as a percentage of all new production rose from 3.9% to 10.6% during this same period. Moreover, data from new well filings at the Federal Energy Regulatory Commission on Exhibit 3 show nonconventional gas as the only category with an increase. All others show a steep decline. In 1990, new nonconventional wells increased 45 percent from 1989 and represented 52 percent of all new well filings made. They also represented 39 percent of estimated new annual gas volumes. That there has been this surge in nonconventional gas drilling when conventional drilling is plummeting has to be attributable to the Section 29 credit.

The Section 29 credit not only helps gas supplies but also consumers and the environment. By making greater supplies available, the credit engenders more competitive pricing in the marketplace and encourages use of domestic gas to help solve our Nation's air quality problems. As you know, three of our top priority air quality

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problems are acid rain, ground-level ozone formation, and global warming. The primary causes of acid rain are believed to be sulfur dioxide (SO_2) and nitrogen oxides (NO_x) emissions. Studies have shown that natural gas can cut emissions of 502 to essentially zero and emissions of NO_x from stationary sources by 10–65 percent and by 80 percent or more in vehicles.

Ozone is said to form when reactive hydrocarbons and NO_x come in contact with sunlight. Using natural gas cuts the NO_x emissions as stated above and virtually eliminates reactive hydrocarbons from stationary sources while reducing their emissions from gasoline-powered vehicles by almost 90 percent.

Global warming is said to be caused by increased concentrations of carbon dioxide (CO_2) in the atmosphere. We know in conventional boilers use of natural gas can reduce CO_2 emissions by 50–70 percent and, in vehicles, by 30 percent as compared to gasoline.

NEED FOR AMT RELIEF

Many producers of nonconventional gas are not able to take full advantage of the Section 29 credit due to the AMT provisions of the Code. This is because accelerated depreciation and IDCs from drilling wells are considered tax "preference items" for purposes of the AMT. These preference items are special tax incentives that increase the amount of AMT. A producer cannot use the Section 29 credit to lower his tax liability below the AMT. Although the taxpayer may be able to carry forward a portion of the credit, the net present value of the credit decreases. However, in any event, the taxpayer forever loses that portion of the Section 29 credit that exceeds the taxpayer's regular tax liability. Without the full credit, many producers are not able to recover the costs expended to drill a well and to make the project economically feasible. Thus, we urge Congress to enact legislation that will enable producers to utilize the Section 29 credit against the AMT. In addition, since the Section 29 credit is permanently lost to the extent it exceeds the regular tax liability for the tax year, we urge Congress to enact legislation to enable the taxpayer to carry forward any portion of the credit not used in a particular tax year.

EQUITABLE'S CASE

In Equitable's case shown below, the Section 29 credit has been an important factor in our decisions to drill nonconventional tight formation, coal seam, and Devonian shale gas wells in the Appalachian Basin. Without the credit, I can safely say our drilling would have been at a much lower level, and with fewer jobs, investment, etc.

State	Number of tax credit wells drilled (1986–91)	Gross gas reserves developed
Kentucky	327	82.0 Bcf
New York	39	4.1 Bcf
Pennsylvania	27	4.1 Bcf
Virginia	295	90.6 Bcf
West Virginia	76	16.0 Bcf
Total	764	196.8 Bcf

CONCLUSION

We think our experience is representative of many producers in the Appalachian Basin and across the country. Equitable recommends that the Section 29 credit be extended under the Code as part of our national energy policy. However, many producers have losses for the tax year and are unable to use the Section 29 credit because of AMT. We urge Congress to remove barriers imposed by the AMT that restrict producers in utilizing the Section 29 credit. Moreover, the taxpayer should be allowed to carry forward any portion of the Section 29 credit that is otherwise permanently lost under current law.

Over the last 10 years, the Section 29 tax credit has proven itself to be a cost-effective means for stimulating substantial additions to the nation's natural gas reserve base. This has benefitted consumers through lower prices, creating jobs and investments, and improving our energy trade balance. On their behalf, we recommend the Section 29 tax credit continue as part of our National Energy and Environmental Strategy and be extended permanently. The importance of an extension is underscored by the general slowdown in conventional gas drilling.

EXHIBIT 1

TABLE 1. TOTAL UNITED STATES GAS RESERVES AND RESOURCES ASSESSED

	TECHNICALLY RECOVERABLE GAS, Tcf*	RECOVERABLE GAS BY PRICE**	
		<$3./Mcf	$3.-5./Mcf
LOWER 48 (Conventional)			
PROVED RESERVES, 12/31/86, ONSHORE AND OFFSHORE	159	159	...
INFERRED RESERVES/ PROBABLE RESOURCES, 12/31/86, ONSHORE	85	85	...
INFERRED RESERVES, 12/31/86, OFFSHORE	23	23	...
EXTENDED RESERVE GROWTH IN NONASSOCIATED FIELDS, ONSHORE	119	56	18
GAS RESOURCES ASSOCIATED WITH OIL RESERVE GROWTH***	61	30	11
UNDISCOVERED ONSHORE RESOURCES	219	88	59
UNDISCOVERED OFFSHORE RESOURCES****	134	54	28
SUBTOTAL	800	495	116
LOWER 48 (Unconventional)			
GAS IN LOW-PERMEABILITY RESERVOIRS	180	70	49
COALBED METHANE	48	8	4
SHALE GAS	31	10	5
SUBTOTAL	1,059	583	174
ALASKA			
ALASKA: RESERVES	33	7#	0
ALASKA INFERRED RESERVES (COOK INLET AREA)	3	3	0
ALASKA UNDISCOVERED, ONSHORE AND OFFSHORE	93	2#	2#
SUBTOTAL	1,188	595	176
TOTAL	1,188	595	176

*Volumes of gas judged recoverable with existing technology

**Volumes of gas (Tcf) judged recoverable with existing technology by Review Panel at wellhead prices shown (1987$)

***Judged at oil prices of <$24./bbl and $24.-40./bbl

****Outer Continental Shelf

#Component in southern Alaska

Source: U.S. Department of Energy, Office of Policy, Planning & Analysis - "An Assessment of the Natural Gas Gas Resource Base of the United States", May 1988.

Exhibit 2

Number of Producing Wells and Annual Production in Lower 48 States by Post-NGPA Category 1978-1987 (Volume in Billion Cubic Feet)

	NGPA Section 107 Devonian Shale, Coal Seam & Other[1]		NGPA Section 107 Tight Formations[2]		All New Post-NGPA Production[3]	
Year	Number of Producing Wells	Total Production (Bcf)	Number of Producing Wells	Total Production (Bcf)	Number of Producing Wells	Total Production (Bcf)
1978	3,981	101	241	14	102,681	3,684
1979	4,202	94	1,059	40	124,785	5,845
1980	4,756	90	5,351	211	151,934	7,683
1981	5,883	91	12,169	495	187,779	9,657
1982	7,367	98	19,774	719	220,047	10,862
1983	8,405	103	25,537	838	244,682	11,189
1984	9,470	112	31,981	1,058	271,620	13,043
1985	10,626	116	38,184	1,201	293,696	13,477
1986	11,255	124	42,470	1,234	304,194	13,648
1987	11,649	145	45,178	1,413	309,803	14,708

[1] Includes reported production enhancement wells.

[2] Includes tight formation wells qualifying under other NGPA categories.

[3] Excludes old gas production under NGPA Sections 104, 105, and 106.

Source: Tables FE1-FE3, September 1989 Natural Gas Monthly, Energy Information Administration, Office of Oil and Gas, Reserves and Natural Gas Division, Title 1 data base.

EXHIBIT 3

Table 8. Well Determination Filings, 1985-1991
(Volume in Billion Cubic Feet)

Year and Month	Section 102[a]			Section 103[b]			Section 107[c]		
	Number of Filings[d]		Estimated Annual Volume[f]	Number of Filings[d]		Estimated Annual Volume[f]	Number of Filings[d]		Estimated Annual Volume[f]
	Total	With Volumes		Total	With Volumes		Total	With Volumes	
1985 Total	9,052	7,028	1,905	15,896	12,531	1,456	10,940	8,766	741
1986 Total	4,631	3,620	1,010	11,348	8,956	959	8,709	4,874	367
1987 Total	2,387	1,787	471	5,717	4,548	532	6,655	4,242	248
1988 Total	2,147	1,508	526	6,359	5,004	563	5,743	3,494	185
1989									
January	124	97	25	389	300	31	385	286	14
February	134	103	28	400	303	54	268	219	14
March	104	78	22	392	317	23	351	234	10
April	131	93	24	384	279	40	286	217	15
May	135	107	29	405	285	30	295	192	21
June	68	44	13	294	199	18	214	136	6
July	137	110	24	462	339	38	298	218	14
August	124	91	28	313	236	24	341	259	28
September	74	61	102	269	195	32	314	268	17
October	87	73	24	448	338	57	385	293	20
November	91	69	21	233	143	20	364	302	22
December	55	41	7	205	128	13	362	229	14
Total	1,262	967	344	4,194	3,080	379	3,831	2,853	195
1990									
January	85	67	17	289	173	24	388	298	21
February	67	54	20	248	155	18	389	262	16
March	122	86	17	291	181	17	714	468	29
April	93	82	18	204	137	11	425	231	22
May	82	71	17	367	213	28	553	378	32
June	45	39	10	297	224	22	468	349	42
July	34	28	7	202	144	20	362	254	21
August	52	29	13	205	139	24	359	221	13
September	58	43	19	208	138	21	493	388	27
October	61	47	11	258	199	22	381	236	22
November	127	108	14	234	144	29	543	349	21
December	50	43	11	163	114	11	473	345	11
Total	865	668	173	2,966	1,981	244	5,548	3,779	279
1991									
January	52	43	10	204	124	12	336	237	18
February	69	59	18	228	153	22	775	626	40
March	32	24	4	210	141	8	375	299	16
April	47	37	9	264	181	18	576	410	24
May	39	31	7	194	134	10	481	271	24
June	11	6	1	108	81	12	296	203	15
July	54	22	3	299	188	13	514	365	24
August	33	24	11	222	179	14	725	498	48
September	14	9	2	127	106	6	507	366	38
1991 YTD	361	295	64	1,843	1,298	118	4,588	3,255	247
1990 YTD	638	489	138	2,311	1,504	182	4,151	2,849	224
1989 YTD	1,028	784	282	3,306	2,453	289	2,720	2,029	139

See footnotes at end or table.

Table 8. Well Determination Filings, 1985-1991 (Continued)
(Volume in Billion Cubic Feet)

Year and Month	Section 108[d]			Total		
	Number of Filings[e]		Estimated Annual Volume[f]	Number of Filings[e]		Estimated Annual Volume[f]
	Total	With Volumes		Total	With Volumes	
1985 Total	9,740	5,304	74	45,628	33,629	4,174
1986 Total	7,215	4,115	50	29,903	21,566	2,383
1987 Total	5,061	3,179	58	19,820	13,756	1,309
1988 Total	4,020	2,602	34	18,269	12,608	1,309
1989						
January	120	71	1	1,018	754	71
February	136	78	1	938	703	96
March	142	61	1	969	690	56
April	170	103	1	971	692	80
May	408	326	1	1,243	910	81
June	163	101	1	737	480	38
July	389	344	2	1,254	1,011	78
August	92	75	1	870	661	78
September	144	80	3	801	604	153
October	380	338	3	1,300	1,042	104
November	145	65	1	833	579	63
December	92	39	1	714	435	35
Total	2,381	1,881	16	11,668	8,561	934
1990						
January	344	311	7	1,106	849	69
February	89	54	1	793	525	55
March	50	30	0	1,177	765	63
April	330	308	3	1,052	758	54
May	66	26	0	1,068	688	75
June	76	32	0	886	644	74
July	116	63	3	714	489	51
August	40	24	0	656	413	50
September	33	22	0	792	591	66
October	36	19	1	736	501	56
November	33	19	0	937	621	65
December	20	5	0	715	507	34
Total	1,233	913	17	10,632	7,351	713
1991						
January	17	8	0	611	412	41
February	78	56	1	1,150	894	31
March	181	22	1	796	486	29
April	63	40	0	950	666	49
May	486	27	0	1,182	463	42
June	18	8	0	430	298	29
July	32	14	3	688	579	43
August	55	36	0	1,035	740	73
September	17	14	0	665	483	44
1991 YTD	949	227	6	7,709	5,023	432
1990 YTD	1,144	870	16	8,244	5,722	557
1989 YTD	1,764	1,239	12	8,821	6,506	731

[a] New natural gas and certain natural gas produced from the Outer Continental Shelf.
[b] New onshore production wells.
[c] High cost natural gas.
[d] Stripper well natural gas.
[e] Not all filings report estimated volumes. The "With Volumes" columns show number reporting volumes.
[f] Annual volumes are often estimated by producers prior to actual operations or based on short periods of operation. For this reason the accuracy of estimates may vary.

Notes: Data for the current month and the previous 2 months are preliminary. All other data are final. Dates shown indicate date received at the FERC. Data include affirmative determinations only. See Explanatory Note 10 for discussion of Title I of the Natural Gas Policy Act. Geographic coverage is the 50 States and the District of Columbia. Totals may not equal sum of components because of independent rounding.

Source: Form FERC-121.

Statement of Focus on the Family

HISTORICAL PERSPECTIVE OF PREFERRED RATES

Postal rates have historically reflected public policy from the earliest days of the republic. Preferred rates were designed to foster the dissemination of public information inuring to the public good through low rates for periodical publications.

Congress recognized the need for and established rate differences for qualifying non-profit organizations in 1917 by exempting publications mailed by these groups from an increase in the rate for advertising matter within the publication. This distinction has continued to the present time in consideration of the perceived benefit to the national community by the activities of such groups and publications.

In 1951 preferred rate status was extended to bulk printed matter distributed by qualifying non-profit organizations by exempting such matter from a rate increase.

In 1970 the Postal Reorganization Act preserved the preferred rates and provided subsidies to make up the lost revenue for the overhead or "institutional" cost to the USPS.

IMPACT TO FOCUS ON THE FAMILY AS A NON-PROFIT MAILER

Focus on the Family has qualified for the preferred rates since it's incorporation in 1977 as a 501c(3) organization. The organization is entirely dependent on the donations received from it's constituency. It publishes seven periodical magazines each of which is specifically designed to meet the needs of particular areas of society. These are: the family unit as a whole, children, teenagers, physicians, and matters of public policy affecting family related issues. The organizations mission is directed towards the preservation of the family unit as the basic building block of our society, traditional family values with their basis found in Judeo-Christian principles and an evangelical approach to sharing the Gospel of Jesus Christ.

This mission is accomplished by providing various resources to families on issues ranging from' marital relationships, child rearing and finances to substance abuse to name a few. Counseling services, both direct and referral, are also provided to those with a need.

Focus on the Family spends five million dollars annually with USPS and depends heavily on postal services for direct mail fund raising and for delivery of resources to nearly two million families.

Postal rates in general have been skyrocketing in recent years, and the revenue forgone subsidy has been steadily eroding. Over the last three years, Focus on the Family has been forced to reduce it's mailing list by twenty three percent. This has been a direct result of increases in postage. Previously our magazine "Focus on the Family" was distributed free to over 2,200,000 families. Five hundred thousand of these names have been removed from this mailing list and we are now only able to reach 1,700,000 families with this publication. Focus on the Family cannot pass these increases on to it's donors. Further reductions will be required if rates continue to spiral.

The financial impact to this ministry (and non-profits as a whole) has been a "double whammy" resulting in cut backs in mail volume. This translates into less effectively reaching those in our society who can benefit the most from our resources; families with median to low incomes that cannot afford to donate on a regular basis if at all. In most cases resources are provided to the requester regardless of ability to contribute the suggested donation amount.

Focus on the Family has a continuing program to prepare it's mail stream to meet USPS automation standards to allow for the most efficient and cost effective delivery of our mail by the postal service. This includes the purchase of barcoding equipment. USPS has sold the mailing community on the idea that doing so would help keep rates down, yet postage costs continue to escalate. Non-profit mailers must have stability in postage rates if we are to continue to serve society.

Focus on the Family is non-competitive with the market place in general since a suggested donation, greater than the fair market value of the premiums offered, is sought. These items are by and large directly or topically related to the goals and purpose of the organization to benefit and strengthen the social fabric of our nation. Many of these resources are produced by the organization and are not available anywhere else in the market place.

The Bush Administration's proposal would deny participation in nearly all of the preferred rate categories by Focus on the Family. This would literally double postage costs and divert an additional four to five million dollars per year (7% of total budget) from the actual services described above, that the organization renders to society.

IMPACT TO SOCIETY

By considering the net impact on all qualifying non-profit organizations, the loss to society could place additional burden on other government (tax payer financed) programs that would be required to fill the voids at a potentially greater cost than revenue forgone.

A further impact would be elimination of jobs and income tax revenue. Non-profits employ many workers who pay income and federal, state and local sales tax. Jobs will certainly be lost due to attempts to reduce overhead to make up for the lost revenue from smaller mailings and higher postage costs. Some of these organizations may have to cease doing business as a result of lost income. This seems counter to the Administration's "Thousand Points of Light" program and the desire to foster economic growth. It would likely have a ripple effect throughout the community.

POSTAL SYSTEM/VOLUME IMPACTS

It is clear from the performance of the USPS itself that the increasing postage costs in general for all third class mail has significantly reduced the volume in this class. Mailers are mailing less than they used to. The Postal Service is not able to furlough the unneeded labor, having to rely solely on attrition to reduce the work force. The result has been a negative productivity rate with increased overhead.

With yet another postal rate case pending for 1994 it is likely this trend will continue. The net result will be even lower productivity, and higher costs to the public. This will have a dynamic impact especially in the area of postal automation, which has been designed to process the "cleaner" automation ready mail pieces and lower overhead costs. The volume will simply not be there to justify the millions of dollars already invested in automation equipment.

Non-profit mailers contribute significantly to this volume of mail. Higher rates and loss of revenue forgone translates into lower volume. The result will be lower productivity and higher costs for handling all mail and will ultimately lead to even further postage increases, not only for third class mail, but for all classes including first class stamps.

Thomas S. Moynihan,C.P.A.
3 Woodledge Road
Stamford, CT 06907
(203) 359-8525

February 14, 1992

Mr. Wayne Hosier
U.S. Senate
Mr. Edward Mihalski
Minority Chief of Staff
Committee on Finance
Washington, D.C. 20510

re: Finance Subcommittee hearing on
long-term growth and competitiveness

Dear Gentlemen:

Thank you for the opportunity to submit this written recommendation for long-term growth and competitiveness of our great country's economy. I want to point out from the start that the business solution is very simple. This solution, though, becomes extremely difficult to implement if it is viewed in a political light.

Unfortunately it is not as easy as just reducing the deficit, raising taxes (if this were the case we would have a surplus we are taxed so much), or reducing expenditures. Fortunately, though, linking long-term growth and competitiveness together is easier.

I have several ideas that, when implemented together, are gauranteed to produce long-term growth and competitiveness for years to come. How many ideas submitted came with a gaurantee like this ?

While the deficit, health care costs, and education woes all hinder the united states' long-term growth and competitiveness, the biggest hinderance is the employer portion of the social security tax. This is, in my opinion, the worst idea ever to be enacted. This huge hinderance can be turned into the United States' biggest weapon for long-term growth and competitiveness. Both the employer's and employee's portion of the social security tax should be put into the employee's "ira" for fifteen years. This ira would have to be invested in one or many mutual funds. This would obviously increase the deficit initially but we'll discuss that later. After fifteen years the employer would stop making contributions to the employee's "ira" and the employee's rate would be increased to ten percent on all earned income. Prior to this the employer's contribution would be based on the first $53,400 of salary. This would create a better environment for small businesses, big businesses, the middle class, and the United States, not to mention both the poor and the rich. There are two keys to this strategy. First the deficit must be minimized - we'll get to this in a minute. The second key is that the baby boomers are nearing their peak earning years. In three decades the number of elderly in the United States will increase 75%. The social security system will not be able to handle this increase.

The employee and spouse will be able to withdraw, upon reaching age 60, all monies in excess of one million dollars (and be taxed on it) to spend in any manner they choose. The one million dollars left in the "ira" would yield passive income to support them in their golden years and will be taken by the government (as a tax) upon the death of the last surviving spouse (provided their dependents are 21 or older). While under age 60, the employee can take out half of the "ira"'s passive earnings to spend on their or their dependent's college education. These two provisions do benefit the rich more than the poor initially but we should reward those that deserve it. If any dependents are under age 22 and their parents are deceased, the income generated from this "ira" can be used for their welfare/education until age 22.

The million dollar tax will eventually pay off the current national debt and all future debt incurred because of this plan as long as spending is kept in check. In the meantime, the deficit will increase but the "national savings deficit" will not. The national savings will increase substantially as the incremental yield (the difference between the interest rate incurred on the national debt and the actual yield incurred by the "ira"s) is compounded annually.

Once enough income from this idea comes into the government coffers to pay for the interest on the national debt, this interest should be taken off budget. At this point (granted it could be 30 years - let the

organizations with the proper authority make the more precise estimates), a thirty year "payment plan" to pay off the national debt should be implemented.

At this thirty year point the employee's contribution rate should be reduced and fixed at 5% of all earned income (this way it is not as regressive).

Employers (at the fifteen year point) would be able to hire more employees, pay for their current employees' health insurance, or spend more on research and development, etc. These items will make the United States' economy more competitive long-term.

Because my idea will initially increase the deficit (but not the "savings deficit"), I have come up with ways to minimize this side effect.

Congress must freeze spending. This action alone would show the country that capitol hill is sincere about fighting the deficit. To do this, COLA(s), in my opinion the second worst idea ever enacted, must be eliminated. COLA(s) fuel both inflation and deficit spending. If the Hill wants to increase spending on a program it should decrease spending on a different program (defense, domestic, etc.).

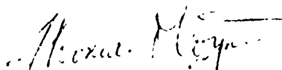
The second way to best minimize my plan's side effects is to deny government payments to anyone earning, exclusive of government payments, in excess of $40,000 or having a net worth of $500,000. This includes social security payments, food stamps, etc. The money saved from this idea would significantly reduce the deficit and balance the budget in a shorter time period than is currently being planned (there is no plan currently).

I have many other great ideas regarding education, politics, government spending, taxation of interest and dividends, capital gains tax rate, government investment in the private sector, trade policy, pension plan simplification, etc.

Because of time limitations I am only submitting one of my concepts. It is a concept that both businesses and unions would actually agree on. I request that you invite me to testify in person the next time this, or a related hearing, is held.

We are nearing a time when economics will drive morality. Both the liberals and the conservatives will agree that we should do anything to avoid this. The country needs action now to ensure we have a great country in the future.

Sincerely,



Thomas S. Moynihan, C.P.A.

STATEMENT OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS AND THE ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

INTRODUCTION AND SUMMARY

This statement is submitted on behalf of the National Association of Life Underwriters ("NALU"), a trade association representing some 140,000 professional life and health insurance agents belonging to over 1,000 state and local life underwriter associations from every part of our nation, and the Association for Advanced Life Underwriting ("AALU"), a conference of NALU whose members specialize in business uses of life insurance.

As part of its fiscal 1993 budget, the Administration has proposed that businesses not be permitted to deduct interest paid or accrued after February 1, 1992, on loans secured by business-owned life insurance policies. The Administration has also proposed that current income tax be imposed on individual-owned annuities without substantial life contingencies.

NALU and AALU strongly urge Congress to reject both of these Administration proposals:

- The proposals are anti-savings, anti-economic growth, and basically unfair to policyholders and the industry.
- The proposal extracts $4.2–4.9 billion from life insurance products. This is unconscionable when just 16 months ago the industry suffered a 50-percent, $8 billion tax hike as it bore the brunt of the 1990 tax bill.
- Imposing the business life insurance proposal retroactively on loans on *existing* life insurance contracts would have devastating effects on the industry and policyholders.

I. THE ADMINISTRATION'S PROPOSALS ARE ANTI-SAVINGS, ANTI-GROWTH, AND BASICALLY UNFAIR

A. Interest on Business Life Insurance Loans

Business life insurance serves many legitimate purposes that should not be discouraged by unnecessary changes in the tax laws. One principal use of such insurance is to protect businesses from the financial drain and economic uncertainty caused by the death of a key employee, owner or officer (so-called "key person" insurance). Upon the loss of a key person, a business faces increased costs to find and train a replacement, to maintain employee morale and productivity, and to preserve product quality and market share. At the same time as it faces these additional costs, the business may suffer from a loss of revenues or a drop in credit rating. These concerns are acutely felt by all businesses, but particularly by the millions of small and medium sized American businesses. Life insurance protects against these risks by paying to the business, as beneficiary under the policy, a death benefit upon the death of the key person.

Another principal use of business life insurance is to preserve the integrity of the business upon the death of an owner. The decedent's heirs may not be in a position to keep their interest in the business and may wish to sell it immediately. Under these circumstances, the remaining owners and employees are faced with the prospect of having the business dissolved, dismantled, or sold to an outsider at a forced sale price. Alternatively, the owner may have entered into contractual arrangements to have the interest sold to the company or to the other owners upon death. In either case, business life insurance provides the business with the funds to buy out the heirs' or the decedent's interest and, therefore, the opportunity to make a smooth transition.

Business life insurance also helps to create assets which provide supplemental compensation packages to attract and retain key employees, as well as employee benefits such as retiree health coverage and survivor benefits. Thus, business life insurance serves many economically and socially useful purposes. Indeed, the importance of such insurance is underscored by the fact that many commercial lenders will not extend credit to a small business for its ongoing needs unless the business adequately insures key individuals and assigns the insurance as collateral to a lender.

Yet these beneficial purposes may be neglected or underserved if interest on business life insurance loans is not deductible. This is because businesses are reluctant to commit to long-term assets such as business life insurance unless those assets can be used as collateral on a tax efficient basis to secure loans to meet unexpected or unusual financial needs. The wisdom of this reluctance is illustrated by the current recession. Even the best managed businesses may be forced in times such as these to borrow against their assets. In better days, such businesses also may need

to borrow against their assets in order to expand, improve, or cover cash flow needs. If business life insurance loan interest becomes nondeductible, such life insurance will be less attractive than other assets and less will-be purchased. Without financial protection against the loss of key people, businesses, especially smaller ones that are particularly dependent on key people, could fail, leaving many people, rank-and-file as well as highly-compensated, without work. Further loss of jobs in the current climate is contrary to the goals of the Administration and Congress to stimulate economic growth and provide tax relief for middle America.

The Administration's fiscal 1993 budget attempts to draw a parallel between loans used to purchase tax-exempt investments and loans secured by the cash value of a life insurance policy, but this comparison is invalid. The needs for which a business uses life insurance and the economic conditions surrounding the business typically change over the years with the result that policies frequently are surrendered or withdrawals are made in excess of basis. This results in taxable income to the policyowner to the extent of the gain. Thus, life insurance is more akin to a tax-deferred investment rather than a tax-exempt investment. The increasing value of a life insurance policy is not essentially different from the increasing value of a stock or bond portfolio, real estate, or any other type of long-term business asset. Businesses can and do borrow against those increasing values when necessary to meet business needs. And the appreciation of these assets is not taxed currently to their owners but rather is deferred, in many cases indefinitely.

Indeed, as compared to other long-term assets, business life insurance already is subject to severe restrictions. As a life—insurance product, business life insurance must satisfy a battery of federal tax requirements that were instituted to ensure that such products were properly used for traditional life insurance objectives rather than primarily as investment vehicles. Furthermore, the law already substantially restricts the interest deduction available for policy loans. No deduction is allowed for interest attributable to the portion of any business life insurance loan that exceeds $50,000 per insured individual. Also, no deduction is allowed for interest incurred pursuant to a plan of purchase which contemplates the systematic borrowing of the cash value of the contract. Thus, there is no justification for eliminating the interest deduction for business life insurance generally while continuing the interest deduction for indebtedness secured by other appreciating capital assets.

Further, the Administration's proposal is anti-savings, again the opposite of the goal sought by Congress and the Administration. Life insurance, at both the business and the individual levels, promotes long-term savings at the same time that it provides necessary protection. To the extent that adequate purchase of life insurance is discouraged by a proposal that places it at a disadvantage vis-a-vis other business assets, it discourages the savings that life insurance pumps into the overall economy.

NALU's and AALU's support of the deductibility of business life insurance loan interest is not meant to suggest that there have not been uses of this product that should be subject to closer scrutiny. But, to the extent that there may have been such uses, they have occurred largely on the margins. The Administration's proposal would penalize all uses of COLI in order to get at the few perceived problem areas. A more reasoned approach is presented by companion legislation that was introduced in the 101st Congress by Senator Pryor and Representative Kennelly. This legislation is targeted at specific problems relating to business life insurance and has the support of the industry.

B. Taxation of Annuities

Annuities are an important retirement savings vehicle, relied upon by millions of Americans. A current tax on an annuity's cash value would eliminate the annuity as an attractive means of saving for retirement, and could therefore result in a substantial decrease in overall retirement savings. This is exactly the opposite result being sought by all those involved in fashioning a tax bill to stimulate economic growth by, among other things, encouraging more savings.

Further, annuities are a middle class retirement savings vehicle. Industry studies have shown that annuities are purchased primarily by middle-income taxpayers who cannot afford to gamble with family assets. Eliminating an important retirement savings option for the middle class would be harmful to the bulk of middle America, and is not justified even as a source of revenue to pay for other middle class tax breaks.

The Administration's proposal effectively would eliminate a broad range of payout options currently available from annuities and would require an irrevocable payout election at the time the annuity is purchased. This ignores that retirees face a wide variety of financial circumstances at retirement that cannot be foreseen when the annuity is purchased. Current annuity contracts address these factors by providing

a flexible menu of payment options that may be elected up to the date when the payout actually begins. By ignoring this need for flexibility, the Administration's proposal, in addition to being anti-savings and anti-economic growth, is unreasonable and unfair.

Finally each major tax act since 1982 has contained provisions restricting the use of annuities. Under current law, for example, distributions from an annuity before retirement age are subject to regular income tax and a tax penalty. Also, a donor must recognize gain when an annuity is transferred as a gift, and an annuity does not qualify for a step-up in basis on the death of the owner. Thus, any inside build-up on an annuity is ultimately taxed to the owner, in contrast to other types of assets, the appreciation on which may escape taxation in a number of ways. Additional restrictions would only further disadvantage annuities as compared to other investment vehicles.

II. TAXING THE LIFE INSURANCE INDUSTRY AGAIN WOULD BE UNCONSCIONABLY HARSH

In October, 1990—just 16 months ago—Congress enacted a 50-percent, $8 billion tax increase on the life insurance industry with the deferred acquisition costs ("DAC") tax rules. The current proposals would hit the products sold by the industry, raising another $4.2–4.9 billion from the industry and policyholders. Under this added tax burden, existing policies would lapse and new sales would be dramatically curtailed. It is unconscionable to slam an industry that provides hundreds of thousands of jobs and billions in long-term capital with two devastating tax increases in less than two years. The other industries that gave their pound of flesh in 1990—gasoline, tobacco, alcohol, airports and telephones—are being let off scot-free this time, while the rest of the business community, which got a free ride in 1990, is being offered tax *cuts*. The life insurance industry has carried more than its fair share of the burden—it should not have to carry any more.

III. RETROACTIVE APPLICATION OF THE BUSINESS LIFE INSURANCE PROPOSAL WOULD HAVE DEVASTATING EFFECTS

Consistent with longstanding Congressional practice in the area of federal tax law, changes in the law affecting life insurance products have always been applied on a prospective basis only. This approach recognizes the potentially severe consequences that would befall both life insurance companies and policyholders if such changes were made retroactively. In the case of the Administration's proposed disallowance of the deduction for business life insurance loan interest, retroactive application would lead to mass surrenders of these policies, severely harming insurers that sell the product and causing loss of jobs. Retroactive application would also seriously impact policyholders.

The potential impact on insurers was highlighted in a February 4th article in the *Wall Street Journal*, which reported that the receiver for Mutual Benefit Life Insurance Co., the troubled New Jersey insurer, expected that enactment of the Administration's proposal would result in the surrender of hundreds of millions of dollars of Mutual Benefit's business, further jeopardizing the company's attempts to get back on its feet. Other life insurance companies face similar woes: in 1991 alone, five other major life insurance companies in addition to Mutual Benefit were seized by state insurance departments because of concerns about financial stability. In short, the Administration could not have picked a worse time to begin retroactive application of changes in the law affecting insurance products.

The impact on policyholders would be no less serious. Businesses that are forced to shift their resources out of business life insurance and into less restricted assets would be exposed to greater risk should a key employee die. Employees and retirees whose retiree health benefits are funded by business life insurance would face greater uncertainty about further health coverage. And business planning would be disrupted and made more difficult, especially for those businesses who have held their insurance policies the longest. It is fundamentally unfair, and poor economic policy besides, to change the tax treatment of long-term arrangements that were made in full compliance with the law.

Retroactive application of the Administration's business life insurance proposal is particularly unfair because it flies in the face of Congress' past practice on this very same issue. In 1986 (as affirmed in 1988) Congress adjusted the rules affecting deductibility of business life insurance loan interest and specifically grandfathered existing contracts. Thus, the Administration's proposal would not only apply to existing contracts previously targeted by Congress on this issue, but would also apply to contracts specifically grandfathered by Congress.

Finally, retroactive application of the Administration's proposal would have a profound effect on the long-term stability of the insurance industry. Businesses and

other life insurance consumers would rightfully question whether any current tax treatment of life insurance products could be relied upon over the life of the contract. Life insurance is a long-term, conservative investment that is made with the basic assumption that the insurer will outlast the policy and that the governing law will remain constant. Retroactive application of changes in insurance law threatens both of these basic assumptions and thereby undermines the faith and confidence that has sustained the life insurance industry from its inception.

Statement of the National Retail Federation

The National Retail Federation is the nation's largest retail trade organization representing 27 national retail associations and 50 state associations. Its membership represents an industry that encompasses over one million U.S. retail establishments, employs nearly 20 million people, and registered 1991 sales in excess of $1.8 trillion. On behalf of the NRF membership, this statement presents our thoughts on the President's tax proposals and how they may affect the retail industry.

The retail industry just suffered through its third bad Christmas season and the Commerce Department data for the year show that the industry experienced its poorest annual showing in three decades. Many well-known retailers have been forced into bankruptcy. In just the past few years, such major retailers as Macy's, Hills Department Stores, Carter Hawley Hale Stores, Ames Department Stores and Federated Department Stores, which includes Bloomingdales, Abraham & Strauss, Jordan Marsh, Burdines, Lazarus and Bon Marche, all have filed for bankruptcy protection. Some fine old stores like Bonwit Teller, Sakowitz, B. Altman, and Garfinckels, right here in Washington, have closed their doors permanently. And the list of those retailers struggling to remain viable in the face of huge losses is too long to repeat.

The NRF believes that the best cure for our struggling industry is a robust economy. Retailers do well when our customers have confidence in their economic well being. However, the current economic news is bleak. Despite some real growth in the third quarter of 1991 there is no evidence of a sustained recovery. Real retail sales are not increasing. Auto sales are flat and production is well below prior year levels. Despite the lowest short-term and long-term interest rates in about twenty years there is no evidence of a sustained recovery in housing and other real estate markets. Unemployment shows no signs of abating.

We applaud the Chairman for holding these hearings on economic growth proposals and for his pledge to move quickly to pass legislation to invigorate our economy. NRF supports a monetary policy that keeps interest rates low and a responsible fiscal policy that speeds economic recovery and enhances prospects for sustained economic growth. In this regard, the NRF is very concerned about the size of the federal deficit and the burden the deficit bears on a weak economy. Although we understand that deficit reduction during a recession could further weaken the economy, we urge Congress not to add to the deficit as a result of their efforts to enact legislation designed to stimulate the economy.

The NRF has traditionally supported an income tax system with the broadest possible base and the lowest possible rates. We believe that such an approach removes the distortions from the tax system and, therefore, provides for greater efficiency and a stronger economy in the long-term.

The NRF also is opposed to consumption taxes. Consumption taxes increase inflation which would reduce consumer spending. A consumption tax would have a particularly severe impact on low-income consumers. Because consumption as a percentage of income falls as income rises, the tax would represent a larger percentage of the income of low-income households than of high-income households.

Given the sluggish national economic performance of recent months, we believe it is prudent for Congress to enact legislation that can create new jobs, restore consumer confidence and promote long-term growth. We believe that certain tax code changes should be evaluated in this context, including broad based individual income and corporate income tax relief, capital gains rate reduction, and investment incentives. In addition, the NRF supports certain targeted tax code changes that are currently under consideration by this Committee, including making the targeted jobs tax credit permanent and repealing luxury excise taxes for jewelry and furs. However, we do not think that tax code changes to stimulate the economy should be enacted at the price of increases in tax rates on individuals or corporations or new forms of consumption taxes.

INDIVIDUAL INCOME TAX RELIEF

NRF believes that individual income tax relief should be broad based and should be implemented quickly. The President's Budget contains several proposals that would provide income tax relief to individuals.

Of the President's proposals, the broadest based relief would be provided through his proposal to increase by $500 the tax exemption for children. Although this proposal would provide relief only to families with children, it would provide tax relief where it is most needed. This tax cut should provide families with more funds to spend on needed goods and services, and this increased consumption should help stimulate the economy and create new jobs.

The President's proposal in this area would not become effective until October 1, 1992, and the exemption would be prorated for 1992. We believe that a more immediate stimulus to the economy is needed. Therefore, we urge the Committee in considering this measure, or other similar individual tax cuts, to provide that the measure be implemented immediately.

We support other more targeted incentives for individuals, as well. For example, we believe that the President's proposals to assist homebuyers, including the credit for first-time homebuyers and the penalty-free withdrawal from IRAs for first-home purchases, will be beneficial to the economy and will help the retail industry. These proposals will generate more housing sales, more construction, and more consumer purchases to furnish these homes. Thus, these increased housing sales are likely to lead to additional job creation and spur consumer confidence.

CAPITAL GAINS RATE REDUCTION

We believe that capital gains rate reduction contributes to longer term economic growth by rewarding investment in new businesses as well as old. The current level of capital gains taxation discriminates against capital income, discourages venture capital formation, impedes job creation, and hinders U.S. competitiveness by raising the cost of capital relative to that of our competitors. Lower capital gains tax rates would stimulate economic growth, promote technological innovation, and create new opportunities. Such increased investment will benefit all sectors of the economy, including the retail industry.

CORPORATE TAX CUTS

The NRF supports corporate tax cuts, which we believe will provide businesses with much needed capital to expand their operations and create jobs. The NRF believes that the most efficient income tax system and the one that will lead to the most sustained economic growth is a system that has the lowest possible rates and the broadest-possible base. Therefore, we prefer corporate tax rate cuts, as proposed by Congressman Rostenkowski, to targeted investment incentives as a means of stimulating the economy. Nonetheless, we believe that investment-oriented tax incentives, like the investment tax allowance proposed by the President, will have a stimulative effect on short-term economic growth.

The corporate alternative minimum tax (AMT) places a very heavy burden on U.S. businesses, especially with the low profit-level we are experiencing in this current recession. Therefore, we support the President's proposal to simplify depreciation under the AMT, as well as Congressman Rostenkowski's proposal to lower the AMT rate.

TARGETED JOBS TAX CREDIT

The retail industry utilizes the targeted jobs tax credit to hire disadvantaged and disabled individuals. Not only does this tax credit cause us to hire individuals who might not otherwise be employable, but also it assists our industry with our high labor costs. Clearly, this credit is an incentive for us to increase employment. The President has proposed that this credit be extended for another 18 month period. We believe that the credit should be made permanent.

LUXURY EXCISE TAXES

Luxury excise taxes were enacted in 1990 as a means to raise revenue on wealthy individuals. As this Committee knows, these taxes did not raise the expected revenue because consumers stopped purchasing luxury items. Instead, those businesses that produce and sell products subject to the luxury excise tax have suffered. The NRF believes that these luxury taxes are counterproductive and should be repealed. The President has proposed repealing luxury excise taxes only for yachts and private aircraft. We believe that this tax should be repealed for jewelry and furs, as well.

FINANCING MECHANISMS FOR ECONOMIC GROWTH TAX MEASURES

The NRF is opposed to using increases in the income tax rates for corporations or individuals or new consumption taxes to finance tax cuts enacted to stimulate economic growth. We believe that financing tax cuts with tax increases is counterproductive because the tax increases will eliminate the fiscal stimulus that the tax cuts are expected to bring. In particular, income tax rate increases and consumption taxes may be even more of a deterrent to economic growth than other types of tax increases. NRF is supportive of the fact that the President's tax proposals are not financed with individual or corporate income tax rate increases or with consumption taxes. We urge this Committee not to adopt such counterproductive tax increases to finance other tax cut measures enacted to stimulate the economy.

CONCLUSION

In summary, the NRF is supportive of the current efforts to craft tax legislation to stimulate economic growth. We look forward to working with this Committee in that endeavor.

STATEMENT OF THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

I. INTRODUCTION AND IDENTIFICATION OF INTEREST

The National Society of Public Accountants consists of 21,000 individual members, most of whom are sole practitioners or partners in small-sized public accounting firms. NSPA members provide accounting, auditing, tax return preparation, representation before the Internal Revenue Service, tax planning, financial planning and managerial advisory services to an estimated six million individual and small business clients nationwide.

Because of the type of clients its members serve, NSPA is in a unique position to address how the imminent expiration of several provisions of the Internal Revenue Code will affect mainstream America. Our members do not audit Fortune 500 companies; they do not prepare taxes for Wall Street brokerage houses. Rather, our members serve Main Street, U.S.A. -- its farmers and small businesses, senior citizens and working families, struggling to make ends meet. When the nation's tax laws change, NSPA members are the first to see the impact on the average American. NSPA is therefore in a unique position to comment on how these people would be affected by the proposed tax law changes currently under consideration.

II. SPECIFIC ISSUES

A. Investment Incentives

1. Investment Tax Allowance

NSPA members believe that the Investment Tax Allowance proposed by President Bush in his State of the Union message will provide a much-needed impetus for the investment decisions of the nation's small business owners. The current recession lingers, and signs that a recovery may be tentative or weak suggest that some stimulus is in order. Many small business owners remain concerned about the future, and their restraint in investment spending reflects this uncertainty. The narrowly-crafted investment tax credit recommended by the President will, in NSPA's opinion, encourage the investment so essential for our economy to recover.

2. Capital Gains

The National Society of Public Accountants recognizes the difficulties inherent in acting on capital gains in such a clearly partisan political environment. Nevertheless, we would encourage the Committee to attempt to reach some sort of bipartisan consensus on this important issue.

While NSPA respects the validity of arguments questioning the distributional effects of a capital gains differential, the National Society believes that such arguments miss the point. It is in the nation's interest to stimulate economic growth and capital formation. It is also in America's interest to remain competitive in a global economy.

One of the essential requirements for meeting these goals is to stimulate the movement of capital at the lowest possible costs. In order to do this, we as a nation have no choice but to make the movement of capital worthwhile for those who possess it. As unpalatable as the means may seem, the end is critical to America's long term economic growth. It is essential for small business capital formation. If the nation is to remain competitive with its foreign trade partners, all of whom have considerably lower capital gains rates, it is vital that this issue be resolved. To the

extent that capital gains does bestow a disproportional tax benefit on certain segments of society, we believe that the distributive effect on the entire economy justifies this disproportional impact.

In this situation, one is reminded of the apocryphal response given by Billy the Kidd when asked why he robs banks: "Because that's where the money is". America must "go to where the capital is". Those who refuse to respect this reality question not only the wisdom of capital gains, but of capitalism itself.

B. Savings Incentives

The National Society of Public Accountants applauds the intent behind President Bush's Family Savings Account (FSA) proposal. America's savings rate is abysmal, and this poor record of savings has an impact in many areas, from Federal deficits to the private cost of capital. American taxpayers need incentives to save more, and that is the principle behind the FSA.

However, we believe that the Congress should go one step further: restore the treatment of Individual Retirement Accounts (IRA's) to their status prior to the Tax Reform Act of 1986. As accountants and tax practitioners, NSPA members can attest first-hand as to the difference deductibility makes in encouraging the decision to open an IRA account. This Committee could achieve many of its long-term policy objectives by restoring the full deductibility of IRA's.

At a minimum, certain anomalies in the current system need to be eliminated. Current restrictions produce unfair results for too many Americans. For example, every working taxpayer who would otherwise qualify should be entitled to an IRA deduction regardless of their spouse's eligibility. Given current marriage failure rates, the present law simply leaves too many Americans without sufficient retirement planning.

Similarly, unless an employee is substantially vested in an employer's retirement plan, an IRA deduction should be permitted. In an age of considerable job mobility, mere participation in a pension plan is not a reliable indicia of adequate retirement savings.

While the National Society believes that the nation's long-term economic interests are best served by a full and complete restoration of IRA deductions, we urge the Committee to at least address these discrepancies in the current law.

C. Expiring Tax Provisions

One of the most important tax issues before this Committee, at least from the perspective of small business, is the expiring deduction for health insurance costs of self-employed persons -- Section 162(l) of the Internal Revenue Code of 1986. Section 162(l) currently allows America's small entrepreneurs -- sole proprietors, partners, and S corporation owner/employees -- to deduct 25% of their health insurance costs as a business expense. By contrast, large corporations permanently enjoy a full 100% deduction for their health insurance expenses.

Once again, this deduction so critical to small business is slated to expire in a few short months. The annual ritual to extend this provision of the Code represents both bad tax policy and bad health care policy.

From a tax policy perspective, the disparity between the <u>25%</u> deduction in Section 162(l) and the <u>100%</u> deduction available to America's corporate giants is perhaps the most blatant example of

discrimination against small business contained in the Internal Revenue Code. As a matter of basic fairness, sound tax policy dictates that parity be restored between "big business" and "small business" by increasing the 162(1) deduction to 100%. America's entrepreneurs deserve no less.

The nation's long-term health care policy is also ill-served by the status quo. With 37 million Americans uninsured, and a disproportionate share of America's working uninsured employed by small businesses, the Federal government should be doing everything it can to encourage low-cost, private sector solutions to the problem.

Unfortunately, Section 162(1) does precisely the opposite. The 25% deduction is often inadequate to enable small business owners to justify the expense of health insurance coverage. Moreover, the uncertainty as to the deduction's future forces many to conclude that they should not risk implementing an insurance program.

Permanent extension and expansion of Section 162(1) is probably one of the most inexpensive options available to the Federal government for improving health insurance coverage in the United States. Mr. Chairman, NSPA is aware that this Committee, along with several of its Subcommittees, has taken a keen interest in health care issues. If Section 162(1) is allowed to expire, there will be costs to the Federal government in terms of increased public expenditures for the medical care of the uninsured. Before concluding that the Federal government cannot afford to make this deduction permanent, we urge the Committee to consider whether it can afford not to do so.

As you know, President Bush included an extension of Section 162(1) in his FY 1993 budget proposal. We applaud the President for recognizing the importance of this issue to the American people. We ask the Congress to take his proposal one step further: make the deduction permanent and increase it to 100%.

D. Taxpayer Rights Provisions

House Budget Committee Chairman Leon Panetta (D-CA) has introduced legislation (H.R. 1485) to allow certified public accountants and enrolled agents to represent taxpayers in small cases before the U.S. Tax Court. The Internal Revenue Code defines a "small case" as one with less than $10,000 in disputed tax. (Code Section 7463).

NSPA believes that Congressman Panetta's bill will greatly simplify appearances before the Tax Court for many taxpayers. Instead of incurring the time and delay involved in retaining counsel, H.R. 1485 allows small case taxpayers to be represented by the one person who knows their tax situation best -- their CPA or EA.

Since present law already permits CPAs and EAs to practice before the Tax Court if they pass a written examination, H.R. 1485 is a logical extension of existing practice rights. Because the formal rules of evidence and procedure which the Tax Court examination tests are waived in small cases, the integrity of the system is in no way compromised.

More importantly, since the IRS is required to consider the hazards of litigation -- to both the taxpayer and the government -- in deciding whether or not to settle a case, Congressman Panetta's bill would essentially "level the playing field" for taxpayers in Appeals. In this respect, NSPA views H.R. 1485 as both a logical

extension of CPAs and EAs practice rights as well as an important procedural safeguard for taxpayers.

NSPA has actively supported this legislation, and urges its consideration in your deliberations.

III. CONCLUSION

The National Society of Public Accountants appreciates the opportunity to express its views on these important issues. If the Committee requires additional information, NSPA stands ready to assist in any way possible. Related enquiries should be directed to Peter M. Berkery, Jr., NSPA's Director of Federal Affairs & Tax Counsel.

STATEMENT OF THE TAX FOUNDATION

"Middle Income Tax Relief and Economic Growth"
March 3, 1992

The Tax Foundation submits the following statement for inclusion in the record of the Finance Committee in connection with its hearings on the President's budget proposals and economic growth. The Tax Foundation is a nonprofit, nonpartisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937

We wish to submit some of the Tax Foundation's recent findings concerning the tax burden on middle-income American families. We share the committee's concerns about the weak state of the economy and the level of tax burden on American families.

Since middle-income tax relief is at the forefront of today's political and economic debate, the Tax Foundation's analysis has strived to answer the most obvious question - how has the middle-income family fared over the past decade? Our median family example uses a household with two earners employed full-time, year-round, with two dependent children. They will earn

Table 1
Two-Earner Median Family Income Before and After Federal Taxes and Inflation
1980-1992

Year	Two-earner Median Family Income (a)	Federal Taxes: Direct Federal Taxes: Income Tax (b)	Federal Taxes: Direct Federal Taxes: Social Security	Federal Taxes: Indirect Taxes (c)	Total	After Tax-Income: Current Dollars	After Tax-Income: 1992 Dollars (d)	1992 Income Gain/Loss	Percent Gain/Loss
1980	$29,627	$4,050	$1,816	$2,149	$8,015	$21,612	$36,592	-	
1981	32,224	4,386	2,143	2,579	9,108	23,116	35,479	($1,113)	-3.0
1982	34,515	4,450	2,313	2,564	9,327	25,188	36,416	937	2.6
1983	36,106	4,300	2,419	2,752	9,471	26,635	37,310	894	2.5
1984	38,713	4,634	2,710	3,108	10,452	28,261	37,949	639	1.7
1985	40,593	4,787	2,862	3,098	10,747	29,846	38,700	751	2.0
1986	42,492	5,158	3,038	3,285	11,481	31,011	39,476	776	2.0
1987	44,536	5,291	3,184	3,305	11,780	32,756	40,229	753	1.9
1988	46,658	5,618	3,504	3,714	12,836	33,822	39,888	(341)	-0.8
1989	49,448	6,126	3,714	3,840	13,680	35,768	40,245	357	0.9
1990	51,095	6,267	3,909	4,067	14,243	36,852	39,339	(906)	-2.3
1991	52,561	6,293	4,021	4,292	14,606	37,955	39,284	(55)	-0.1
1992 e	54,926	6,469	4,202	4,581	15,252	39,674	39,674	390	1.0

(a) Median income for household with two earners employed full time-time, year round.
(b) Married couple filing joint return, two dependent children.
(c) Estimated average indirect federal taxes. Includes excise taxes, employer's share of Social Security taxes, and miscellaneous levies
(d) Adjusted by consumer price index (CPI-U), estimated 3.5 inflation in 1992.
(e) Based on OMB and CBO estimates of personal income growth.

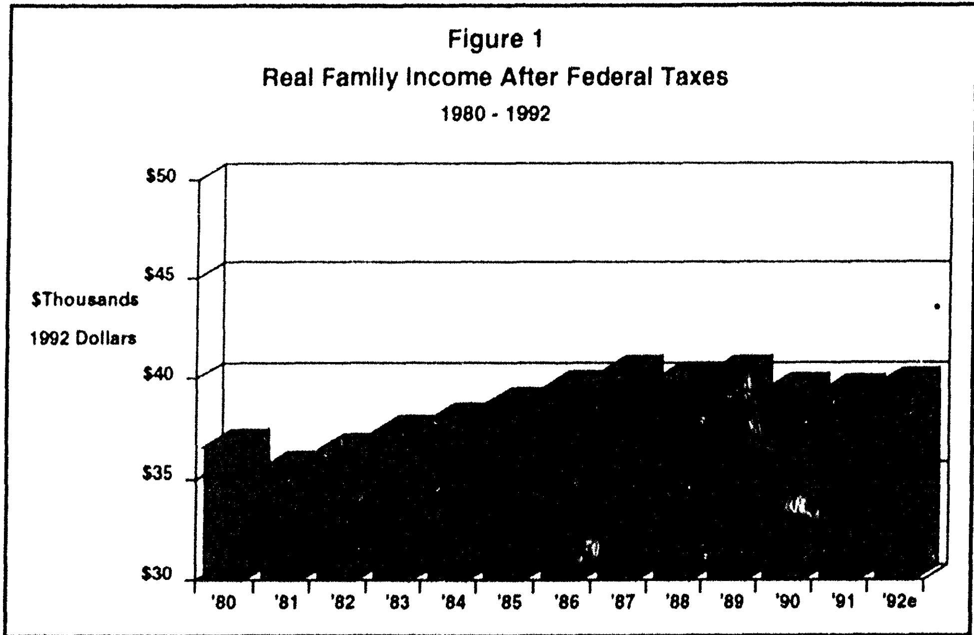
Sources: Tax Foundation; U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; U S Department of Labor, Bureau of Labor Statistics; U.S. Treasury Department, Internal Revenue Service.

an estimated $54,926 in 1992, compared to $52,561 in 1991, a 4.5 percent increase. Unfortunately, the additional $2,365 they earn in 1992 will be reduced to only $390 after federal taxes and inflation — and this is before they pay any state and local taxes. As presented in table 1, the typical family income growth has been greatly eroded by federal taxes and inflation. In fact, Tax Foundation analysis shows that the family has lost real purchasing power in three of the last five years (see figure 1). Since 1980, this typical family's real income growth after federal taxes has averaged only 0.7 percent.

The two-earner family making $29,627 back in 1980 is now earning an estimated $54,926. But when federal taxes and inflation have taken their cuts from this $25,299 increase, a mere $3,082 is left, nearly a 90 percent loss.

The Bite of Direct Federal Taxes

Since 1980, the typical family's federal income tax bill has risen 60 percent despite the decade's two major income tax rate reductions: the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986. These pieces of legislation did lighten the individual income tax burden, but their benefits to the typical family have been overwhelmed, principally by the rising toll of the Social Security tax. Six times since 1980, the Social Security tax rate has increased, so that it now takes in 7.65 percent of the family's total earnings, up from 6.1 percent in 1980. The level of earnings to which this tax is applied has also been ratcheted up under a system of automatic adjustments. This combination of higher rates and a larger income base has increased



the bite that Social Security takes out of the typical family's income to $4,202 in 1992.

Combined, income and Social Security taxes will absorb 19.4 percent of family income in 1992, down only slightly from the 1981 peak of 20.3 percent. The employer's matching share of this rising Social Security tax burden increases the cost of labor, lowers real wages, and reduces job growth. Therefore, any real attempt to reduce the growing tax burden must consider the high Social Security tax levied on families, as well as employers.

While direct federal taxes — the employee's share of Social Security and income taxes — have largely eroded the family's income gains since 1980, another disturbing trend is the increase in indirect taxes paid by middle-income families. Indirect taxes, such as the employer's share of Social Security taxes, corporate income taxes, and excise taxes on such items as gasoline, liquor, tobacco, and telephone use will add an estimated $4,581 to this middle-income family's tax bill, taking a record high 8.3 percent of its total income. This is a full percentage point higher than the 7.3 percent of family income that indirect taxes absorbed in 1980.

Many of these indirect taxes were raised with the enactment of the 1990 budget agreement, which increased taxes by $164 billion over 5 years. Most notably, taxes were increased on gasoline (9 to 14 cents per gallon), cigarettes (16 to 20 cents per pack), and beer (16 to 31 cents per 6-pack) and the telephone excise tax was made permanent at 3 percent. Therefore, the level of tax relief in 1992 and beyond cannot ignore the estimated $35 billion in new taxes to be collected this year alone, as a result of the 1990 budget agreement.

Additionally, the family's tax burden cannot be examined properly without analysis of state and local tax levies. Last year, alone, states collectively increased taxes by $17 billion. That tax increase will greatly impact families this year. Tax Foundation analysis shows that in some large states, 1992 tax burdens will increase by over $200 per person (see table 2). The sharp increase in state and local taxes in many states must be considered when examining proposals to provide real tax relief for

Table 2

Projected 1992 State Tax Increases

Per Capita

State	Per Capita State Tax Increase
Alabama	$42.57
Alaska	1.82
Arizona	2.48
Arkansas	112.60
California	220.70
Colorado	·
Connecticut	315.02
Delaware	141.86
Florida	3.95
Georgia	·
Hawaii	43.31
Idaho	12 61
Illinois	71 47
Indiana	7.70
Iowa	4.90
Kansas	·
Kentucky	·
Louisiana	74.65
Maine	216.63
Maryland	18.84
Massachusetts	·
Michigan	(1.08)
Minnesota	65 76
Mississippi	·
Missouri	·
Montana	(5.89)
Nebraska	10.96
Nevada	116.99
New Hampshire	55.62
New Jersey	(2.59)
New Mexico	17.89
New York	66.70
North Carolina	93.07
North Dakota	(0.16)
Ohio	11.26
Oklahoma	·
Oregon	32.56
Pennsylvania	277.91
Rhode Island	130.35
South Carolina	3.04
South Dakota	·
Tennessee	1.13
Texas	47.04
Utah	2.84
Vermont	160.10
Virginia	5.37
Washington	2.20
West Virginia	·
Wisconsin	58.20
Wyoming	·
District of Columbia	73.32

Sources: National Conference of State Legislatures, and Tax Foundation survey of revenue departments, legislative officials, and governors' offices.

American families.

The Family's Ability to Spend, Save and Invest

Federal, state and local taxes are the largest item in the family's 1992 budget (see table 3 & figure 2). The Tax Foundation estimates that the typical American family will spend 39.7 percent of its 1992 budget on taxes, more than on food, clothing, and housing combined. After paying its tax burden and purchasing necessities, the typical family has only 29 cents left on a dollar to pay for such items as health care, transportation, insurance, and, of course, to put into savings.

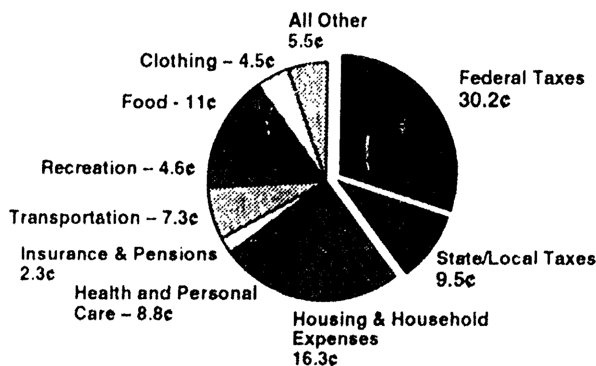
The current family savings rate is below 3 percent and well below the historic 6 percent level. Clearly, proposed tax relief will at least allow the family more disposable income to help boost private savings and/or consumption - both of which will benefit the economy.

Table 3
The Average Family's 1992 Budget After Taxes[a]

Spending Category	Dollar Amount	Percent of Income
Family Income	$54,926	100.0%
Total Taxes	21,826	39.7
Federal Taxes	16,608	30.2
State and Local Taxes	5,218	9.5
After Tax Income	33,100	60.3
Total Personal Consumption Expenditures	33,100	60.3
Housing and Household Operations	8,927	16.3
Food and Tobacco	6,061	11.0
Health/Personal care	4,853	8.8
Transportation	4,012	7.3
Recreation	2,545	4.6
Clothing	2,456	4.5
Personal Insurance and Pensions	1,255	2.3
All Other	2,991	5.5

[a] This example uses a two-earner family earning $54,926 per year with two dependent children.
Source: Tax Foundation

Figure 2
How the Typical American Family Will Spend a Dollar in 1992[a]



[a] This example uses a two-earner family earning $54,926 per year with two dependent children.
Source: Tax Foundation

Current Proposals

No one single tax policy change is likely to stimulate a significant increase in economic growth, as well as provide large amounts of tax relief. The best tax cuts are the ones which will encourage people to work, save and invest. Therefore, a mix of several tax-relief and economic growth measures may offer the best hope of increasing savings

and investment. In order to help quantify the impact of the major tax-relief and economic growth proposals currently on the table, the Tax Foundation calculated the likely net savings to the family if each were fully enacted. Tables 4 and 5 present the net savings from the major tax-relief proposals currently being debated for families earning $54,926 and $30,000, respectively. Including the effects of capital gains tax reduction and first-time homebuyer tax credits, the $54,926 income family can realize anywhere between $275 to $3,410 in first-year tax savings.

More important than the actual dollar amount of the tax- relief plans' net family savings is their ability to foster long- term economic growth without significantly increasing the federal budget deficit, already estimated at a record $366 billion this year and representing 6.2 percent of Gross Domestic Product (GDP). The deficit represents net dissavings in the national economy.

Table 4

1992 Major Federal Tax Relief Proposals' Impact on Typical American Family (a)

Proposal	Family Income(b)	Income Tax	Social Security Tax	Total Tax	Net Savings
Current Law	$54,926	$6,469	$4,202	$10,671	-
Bush	54,926	6,189	4,202	10,391	$280
Bentsen	54,926	5,309	4,202	9,511	1,160
Bradley	54,926	5,769	4,202	9,971	700
Coats/Grassley/Wolf	54,926	5,542	4,202	9,744	927
Dreier	54,926	5,318	4,202	9,520	1,151
Gore/Downey	54,926	6,157	4,202	10,359	312
Gramm/Gingrich	54,926	6,469	4,202	10,671	(c)
Kasten/Weber	54,926	5,169	4,202	9,371	1,300
Moynihan(d)	54,926	6,469	3,927	10,396	275
Packwood	54,926	5,822	4,202	10,024	647
Rostenkowski	54,926	6,069	4,202	10,271	400
Roth	54,926	4,776	4,202	8,978	1,693
Schulze	54,926	5,797	3,653	9,450	1,221
Walker	54,926	4,852	4,202	9,054	1,617
Wallop/DeLay	54,926	6,469	3,708	10,177	494
		Capital Gains(e)			**Net Savings**
Bush	54,926	5,839			630
Bumpers	54,926	5,769			700
Gramm/Gingrich	54,926	6,049			420
Kasten/Weber	54,926	5,819			650
Schulze	54,926	6,049			420
Walker	54,926	6,007			462
Wallop/DeLay	54,926	5,819			650
House Republican Conference Committee	54,926	6,049			420

Savings from First-Time Homebuyer Tax Credit

	1992	1993
Bush ($5,000 over 2 years)	$2,500	$2,500

(a) First-year impact of direct changes in the personal income tax, employee Social Security tax, personal exemption, personal tax credits, and deductible IRA investments.
(b) Estimated median two-earner income for married couple household. File joint return; two dependent children ages 4 and 7. Family invests $2,000 in new deductible IRA account
(c) Plan allows tax-free withdrawal of IRA and $1,000 tax credit for first time home-buyer not examined in this example.
(d) Additional future reductions in the payroll tax rate are scheduled.
(e) Example assumes $5,000 in fully qualifying capital gains included in the $54,926 income
Source: Tax Foundation.

Therefore, any meaningful tax changes targeted to increase personal savings should not be counterproductive by increasing the deficit. Many of the current tax-relief proposals already recognize this relationship and offer offsetting federal spending reductions in conjunction with their tax reductions. What should be avoided is merely shifting the cost of any tax relief among various income groups. Simply shifting a portion of the tax burden from one individual to another does not reduce the overall level of taxation and offers little hope of increasing savings and investment, and spurring economic growth.

Table 5

1992 Major Federal Tax Relief Proposals' Impact on Typical American Family (a)

Proposal	Family Income(b)	Income Tax	Social Security Tax	Total Tax	Net Savings
Current Law	$30,000	$2,220	$2,295	$4,515	-
Bush	30,000	2,070	2,295	4,365	$150
Bentsen	30,000	1,320	2,295	3,615	900
Bradley	30,000	1,520	2,295	3,815	700
Coats/Grassley/Wolf	30,000	1,360	2,295	3,655	860
Dreier	30,000	1,728	2,295	4,023	492
Gore/Downey	30,000	1,310	2,295	3,605	910
Gramm/Gingrich	30,000	2,220	2,295	4,515	(c)
Kasten/Weber	30,000	920	2,295	3,215	1,300
Moynihan(d)	30,000	2,220	2,145	4,365	150
Packwood	30,000	1,998	2,295	4,293	222
Rostenkowski	30,000	1,820	2,295	4,115	400
Roth	30,000	1,536	2,295	3,831	684
Schulze	30,000	1,860	1,995	3,855	660
Walker	30,000	1,665	2,295	3,960	555
Wallop/DeLay	30,000	2,220	2,025	4,245	270
		Capital Gains(e)			**Net Savings**
Bush	30,000	1,882			338
Bumpers	30,000	1,845			375
Gramm/Gingrich	30,000	1,995			225
Kasten/Weber	30,000	1,845			375
Schulze	30,000	1,995			225
Walker	30,000	1,972			248
Wallop/DeLay	30,000	1,845			375
House Republican Conference Committee	30,000	1,995			225
	Savings from First-Time Homebuyer Tax Credit				
	1992	1993			
Bush ($5,000 over 2 years)	$2,500	$2,500			
Bob Graham	2,000				
Gramm/Gingrich	1,000				
Walker	1,000				

(a) First-year impact of direct changes in the personal income tax, employee Social Security tax, personal exemption, personal tax credits, and deductible IRA investments
(b) Estimated income for married couple household. File joint return, two dependent children ages 4 and 7. Family invests $2,000 in new deductible IRA account.
(c) Plan allows tax-free withdrawal of IRA and $1,000 tax credit for first time home-buyer not examined in this example
(d) Additional future reductions in the payroll tax rate are scheduled.
(e) Example assumes $5,000 in fully qualifying capital gains included in the $30,000 income
Source: Tax Foundation

Short-Term vs. Long-Term

While the typical American family currently faces a record total tax burden, which warrants immediate attention, any tax relief should also be carefully considered in terms of its impact on long-term economic growth. Quick-fix, temporary tax changes may do more harm than good. Any family tax relief provided today should not reduce the family's future potential income gains by reducing GDP and/or sharply increasing inflation and interest rates. A strong economy over the long term increases the family's earnings potential and provides the best opportunity for the family to save, spend, or invest.

Any tax change that is good in the short-term should also be good for the long-term. Temporary tax changes should be avoided. Temporary or uncertain changes tend to have a limited impact on the economy. Additionally, any tax changes should adhere to the principles of sound tax policy. The Tax Foundation's principles of taxation are outlined below:

- A good tax system requires that taxpayers be informed. They must know what is being taxed and how tax legislation is enacted.
- The tax system should be as simple as possible. Complexity makes accurate tax compliance needlessly expensive and punitive.
- Tax law should not be continually rewritten. Frequent change lessens citizen understanding of the tax code and complicates long-range financial planning.
- Changes in tax law should not be retroactive. Taxpayers must have confidence in the law as it exists when entering into a transaction.
- The tax law should not try to micromanage the economy with subsidies and penalties. The tax system should aim for neutrality in economic decision making, favoring neither consumption nor savings and investment.
- The U.S. tax system must be competitive with those of other industrialized nations. It should not impede the free flow of goods, services and capital.

The Tax Foundation calculated that last year, Tax Freedom Day fell on May 8th -- the latest date on record. That meant the average American had to work 128 days from January 1 through May 8th to pay his or her total federal, state, and local tax bill. Currently, taxes represent the largest item in the typical family's budget. The tax-relief proposals being debated represent a welcome step in alleviating this burden, but they must also promote long-term economic growth. After a decade of weak income gains and increasing tax burdens, the American family certainly deserves a wholesome dose of tax relief and an opportunity for strong income growth.