REVENUE ACT OF 1978

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 13511

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO REDUCE INCOME TAXES, AND FOR OTHER PURPOSES

AUGUST 17, 21, 22, 23, 24, 25, AND SEPTEMBER 6, 1978

PART 2 OF 6 PARTS

(AUGUST 21 AND 22, 1978)

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REVENUE ACT OF 1978

MONDAY, AUGUST 21, 1978

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

The committee met, pursuant to notice, at 10 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Ribicoff, Bentsen, Moynihan, Curtis, Hansen, Packwood, Roth, Jr., and Danforth.

The CHAIRMAN. This morning we are limiting witnesses on panels to 5 minutes to summarize their statements. Your entire statement, of course, will be printed in the record.

We have a panel of three, which will be allowed 15 minutes for the panel—5 minutes for each witness, 15 for the panel. If there is a panel of four witnesses, they will be allowed 20 minutes.

The Senator from Missouri, Mr. Danforth, is recognized for five minutes.

Senator DANFORTH. Thank you, Mr. Chairman.

Mr. Chairman, I want to share a few thoughts with the committee as we begin hearings on this bill. The country's economy is entering a very precarious period. Internationally, the dollar is in serious trouble. This problem plays havoc with the domestic economy and threatens the viability of the international monetary system.

We seem incapable of reducing our trade deficit. We are increasingly dependent upon foreign oil, and its price constantly threatens to increase. Domestically, inflation continues unabated. Business confidence has been seriously eroded, and this fact is reflected in the dangerously low rate of capital investment we are looking at today and facing in the future.

Productivity growth for the past 10 years in our economy has lagged behind every other industrialized nation except Great Britain—we are tied for last with the English.

We must create millions of new jobs in the next 8 to 10 years, and business cannot do it in this environment.

Paper profits are up, but when adjusted for inflation, these profits are grossly overinflated. Many industries are debt-financed up to their limits. When these financial problems are considered in combination with the international uncertainties, the Federal budget deficit is up to $40 or $50 billion, and expensive and often counterproductive Federal regulations, there is no wonder that business confidence is dangerously low.

The House bill provides some help but, in my view, it does not go far enough.

During the course of this committee's deliberations, it is my hope that, at a minimum, we can add the following items to this legislation: One, increase incentives for capital investment; two, additional tax reductions for individuals; and three, a tax measure to help control Federal spending.

I would like to discuss these very, very briefly, in order.

First, increase incentives for capital investment. My own top priority in this regard is a larger cut in the maximum corporate tax rate. Possibly, this cut could be phased in over 3 to 5 years. I would also hope that we could give careful attention to several alternatives for helping business to recover fully the cost of new capital investment; that is, to address for effects of inflation on undepreciable assets.

It may be that we also should increase the investment tax credit, but the important point is that we must encourage business investment in this tax bill.

I say this with some political trepidation because of the risk of being branded a Republican tool of business. However, in testimony last week before this committee, Secretary Blumenthal made precisely the same point. I was encouraged and impressed by the Secretary's statement and that he was open to considering more incentives for capital investment in this bill.

Second, additional tax reductions on individuals. The House bill takes an important and needed step in tax reductions for individuals. However, it does not go far enough. The House bill would grant to all individuals protection for 1 year against most of the impact of inflation's pushing them into higher brackets. I hope that this committee will extend that protection for at least an additional 2, or perhaps 3 years.

Finally, the tax measure to help control Federal spending. I think that it is imprudent to talk about tax reductions without talking about cuts in Federal spending.

At the current high point in our post recession recovery, it is appalling to realize that Federal spending as a percent of GNP is at a 30-year high—22.3 percent. It is no wonder that we have a $50 billion Federal deficit.

Last week I, along with Senators Bellmon and Proxmire, introduced a measure that would limit to 2 percent the rate at which real Federal spending can grow annually. If the Federal spending exceeds 2 percent, the excess would be funded on the income tax.

The principle behind this measure is that no politician wants to increase taxes, but the threat of tax increases would give us a discipline that we currently do not have.

That, Mr. Chairman, is what I think we should add to this bill: one, increased incentives for improved capitol investment; two, additional tax reductions for individuals; and three, a tax measure to help control Federal spending.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Now we will call a panel consisting of Roland M. Bixler on behalf of the National Association of Manufacturers; Mr. Wallace J. Clarfield, on behalf of the tax council; and Dr. Jack Carlson, vice president and chief economist, Chamber of Commerce of the United States.

You have 5 minutes each, gentlemen; 15 for the panel.

STATEMENT OF ROLAND M. BIXLER, PRESIDENT, JBT INSTRUMENTS, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. BIXLER. Mr. Chairman, my name is Roland M. Bixler. I am President of JBT Instruments, Inc., in New Haven, Conn. I represent the National Association of Manufacturers as a member of its board of directors and as chairman of its committee on taxation. Accompanying me is Cliff Massa III, assistant vice president and director of taxation for NAM.

The NAM is made up of 12,400 member firms, which employ a majority of the country's industrial labor force and which produce over 75 percent of the Nation's manufactured goods, and we represent an additional 125,000 firms affiliated with the NAM through the National Industrial Council. Over 80 percent of NAM members are generally classified as small businesses. I am a small businessman myself, as an owner-manager of an electronic manufacturing firm employing fewer than 100 persons.

H.R. 13511, the tax reduction bill adopted by the House, is a significant step in the right direction on tax reductions and capital formation and can serve as a solid foundation for construction of a more effective package. NAM has expressed support for and continues to recommend a somewhat larger total tax cut and particularly a further reduction in the corporate rate. In addition, we strongly favor a two-tier corporate rate rather than the series of graduated steps currently included in the bill.

I also want to reiterate NAM's strong support for the use of econometric analysis for measuring the ripple effects and net revenue impact of tax proposals such as H.R. 13511 and others before this committee. Four years ago this month, the NAM started the tax impact project, known as TIP, to develop the capability to move beyond the static revenue estimate by which tax proposals had been judged traditionally. My written statement includes an extensive appendix (pages 1-9 of appendix B) which introduces this type of analysis for H.R. 13511 and an alternative larger corporate rate cut. These new figures, based upon 4 years of experience, come from the Ture-TIP model, developed by Norman B. Ture, Inc., of Washington, D.C. with sponsorship by TIP.

Dr. Ture and his colleagues stress the dynamic effects of tax changes on the supply side factors of the economy, such as the availability and overall cost of capital. We appreciate the continuing interest expressed by Chairman Long and other members of the committee in support of this type of analysis. We are pleased to note that Secretary Blumenthal in his testimony before you on August 17 also recognized the importance of estimating supply side effects of tax changes.

While supporting a tax reduction on the order of up to $25 billion, we recognize the potential for adversely affecting the Federal deficit and inflation. The impact on the deficit can be eased both by spending cuts and by a well-reasoned mix of reductions within the package. All tax reductions do not affect all taxpayers in the same way, so they do not produce the same kind of economic effects.

The Ture-TIP analysis of H.R. 13511 indicates that, dollar for dollar, the reduction in the corporate income tax rate in general has a greater impact on the level of investment and a larger feedback effect

on net revenues than do the individual tax reduction. My written statement explains this result in some detail.

What this suggests is that a significant portion of the general tax cut should be provided to the corporate sector, particularly since the level of business investment has been disappointing and the Federal deficit needs to be restrained. Thus, providing one-third of the package to business would be desirable.

For many years, the business community has supported an across-the-board rate reduction as the simplest, most equitable and most stable form of tax cut. NAM applauds the administration's emphasis in this area, and we urge this committee to adopt general rate-cuts as the centerpiece for a general tax reduction package.

We have supported a tax cut of close to $25 billion which would allow a larger corporation rate cut than is provided in H.R. 13511. A 3-percentage rate-cut to a 17-percentage bottom rate and a 45-percent top rate, plus an increase in the current $50,000 corporate surtax exemption to $100,000 would actually produce a net revenue gain of about $1 billion in the first year, with a sizable increase in total investment and gross national product, according to the newest figures in the Ture/Tip analysis.

This is in contrast to an approximate $8.2 billion revenue loss in 1979 using a static estimate based on Treasury figures. Now, again, we recognize the realities of the budget resolution situation and we feel that larger reduction in H.R. 13511 is desirable.

Thank you very much.

The CHAIRMAN. Mr. Clarfield?

STATEMENT OF WALLACE J. CLARFIELD, ON BEHALF OF THE TAX COUNCIL

Mr. CLARFIELD. My name is Wallace J. Clarfield, on behalf of the Tax Council.

Mr. Chairman, because of the rush of getting our statement in last Friday, we were unable to include any comments about the Secretary's testimony, and we have submitted some additional data that I would request be included in the record.

Generally, the council feels that the bill is a good bill, and we support it. We applaud the corporate rate reduction. We believe more must be done in this area, and we think this is a good start.

For the investment credit, we approve making it permanent and we approve the provision that would permit an offset of up to 90 percent of a corporation's Federal income tax for investment purposes.

We would recommend that, instead of being phased in at 10 percent a year, that at the outset to be increased to 70 percent, that an additional 10 percent increments, thereby giving a medium infusion to businesses, which certainly need this help right now.

As far as pollution control facilities and the investment credit changes there, pollution control is a very expensive proposition for American businesses today. We all recognize the need for it, but we certainly need help in getting the capital.

Pollution control facilities not only cost a lot of money which are nonproductive in terms of return to the investor, but they cost a lot of money to operate.

As far as individuals, we think that the rate reduction schedule under the bill is not only fair, but it starts to correct some of the inequities that have been built into the system over many years. The middle and upper income groups need relief in this country. Recent statistics indicate that taxpayers having an adjusted gross income of $25,000 or more, although constituting only 10 percent of the taxpaying public, actually pay 50 percent of all individual taxes; and the taxpayers having an adjusted gross income of $17,000 or more, although constituting only 25 percent of the taxpaying public, pay about 72 percent of all individual taxes.

Consequently, arguments that the bill is weighted in favor of high-income groups is fallacious; since the taxes are weighted in the direction of higher income groups, it is only appropriate that reductions be weighted in the same way, if the same degree of progressivity is to be maintained as time goes on.

Here I would like to point out that the Secretary, on Thursday, again made the point that he would like tax reduction to be in the form of an increased credit for individual exemptions instead of an increase in the deduction for exemptions. We should point out that credits, or deductions, retain progressivity without making any change in the relative progressivity of the tax system.

Credits compound progressivity. Every time you switch a deduction to a credit, you are increasing progressivity, and question why should the progression of the tax system go up every time we have a tax cut?

Furthermore, aside from the basic question of fairness, we should point out that higher income groups are the ones who, in fact, are able to save and enhance capital formation, and this bill is a step in enhancing that capital formation.

We support the capital gains proposal. We do not think that this, again, is a rich man's bill—unless you argue that anybody earning over $17,000 is rich in this country.

We think that the minimum tax on capital gains is an unfair tax, unless it is truly an alternative tax. Right now it is an add-on tax and it is not fair for those who have capital gains. The maximum tax consequences are very unfair. They really hurt people who have earned income. They are the people in this country who are the producers. If they happen to have some capital gain, they really get hurt.

On other items, we support the taxation of unemployment compensation. We think that the bill makes only a start. We should not have a system whereby we encourage people not to work by paying them a subsidy.

In summary, we agree with the bill's provisions on deferred compensation. We think it is a fair and timely manner, and I am out of time, Mr. Chairman.

Thank you.

The CHAIRMAN. Thank you.

Mr. Carlson?

[The prepared statement of Jack Carlson follows:]

STATEMENT OF JACK CARLSON, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. CARLSON. Thank you, Mr. Chairman.

My name is Jack Carlson. I am vice president and chief economist of the Chamber of Commerce of the United States.

The National Chamber recommends that the Senate adopt a program of substantial tax relief, accompanied by realistic but firm limitations on the growth of Federal spending.

We recommend $25 to $30 billion of tax relief on an annual basis, about twice as much as passed by the House, smaller than the 1975 tax cut, sized to the 1979 economy, and about half the size of the 1963-64 tax relief.

We recommend targeting one-third, or $8 to $10 billion of the tax relief to encourage job creating, capacity expanding, and inflation-dampening investment; and a $32 billion, or 7-percent limit, to the growth of Federal outlays. This would be enough to provide for current services and prior commitments. And we recommend that the Second Concurrent Budget Resolution would be the place to come down on the size of the tax relief, as well as spending limitations.

We recommend limiting the growth of Federal budget authority which is excessively building up spending for fiscal years 1980 and 1981. We recommend limiting the Federal deficit to $35 to $40 billion required to bring down inflation, allow interest rates to subside, and help with the decline of the dollar.

Specifically, we believe that this committee should reduce the top corporate rates by at least 4 percentage points, reduce the corporate tax rate on small business to a greater extent than is contained in H.R. 13511, liberalize the investment tax credit including extending it to all productive structures and without limitation based on tax liability, reduce the tax on capital gains by at least $2 billion, as contained in the Hansen-Steiger bill, and contrary to the Treasury's analysis—in fact it is so discouraging reading the Secretary of the Treasury's statement when he says his estimates for particular tax changes, including the Hansen-Steiger bill do not include feedback effects.

If you look at the feedback effects, two-thirds of the benefits will go to middle and lower income people because those are the people who fill the additional jobs that will be created by that bill.

We also believe we should move toward a complete capital cost recovery system immediately or over time, as suggested by Senator Danforth, and begin to eliminate the double taxation of corporate income.

The National Chamber also urges an across-the-board reduction in individual tax rates of $17 billion to $20 billion. We have not had one since 1964, and we have discriminated against this group of taxpayers.

The Chamber is specifically concerned about the heavy burden of taxation facing small businesses. Since 1964, only one tax measure has given significant relief to small businesses—the creation of the 22 percent break before the second $25,000 of taxable income and the reduction in the tax rate from 22 to 20 percent on the first $25,000—yet prices have doubled in those 14 years, leaving many small businesses with lower real after-tax income. It is time for the Congress to redress this loss by raising the current surtax exemption and lowering the corporate rates rather than by adopting the anemic, complicated and piecemeal graduated rates and multiple brackets approved by the House.

Instead, we advocate a $200,000 surtax exemption with a 15 percent rate applied to the first $50,000 of taxable income. This gives more needed tax relief than in the House bill.

We are concerned, as everybody is, as the editorial writers are, about the declining dollar. This is not the time to increase taxes on exports without a substitute, and there is no substitute being proposed; thereby, to phase out DISC and deferral is irresponsible in these conditions.

Thank you, Mr. Chairman.

The CHAIRMAN. We thank each of you for your statements. Gentlemen, I think that all three of you reflect something that is of concern to me. I think the one reason taxes are so very high on business is so far we have not been able to find a way to demonstrate that the taxes are counterproductive. When we passed the investment tax credit, it was estimated that we were losing for the Government about $1 billion for each point. So a 10 percent investment tax credit goes down as though the Government is losing $10 billion on the investment tax credit.

When we repealed the credit, instead of making money we lost money. We lost as much as we thought we were going to make. When we enacted the credit, instead of losing money, we made money—just the reverse effect of the revenue estimates every step of the way. This tends to prove to me that we have taxes so high on the ablest and most productive people in this economy and also on our corporations that they are defeating their own purpose. They are bringing us less revenue when they would bring us more if the rate were not so ridiculously high.

I do not know how we are going to prove it. The Treasury does not want to look at this.

I compared it, in talking to one of the Treasury people, to the situation where you shoot at a duck flying across the duck blind. If you shoot aiming at the duck, there is no way you can hit it, you have to aim in front of where the duck is to have a chance of hitting it.

Treasury said, when you make revenue estimates like that, you are speculating. It is something nebulous.

My reaction is, if you do it the way you are doing it now, which is like shooting by aiming at a target moving across in front of you, you cannot do anything but miss. You have to be wrong when you do it the way you are doing now. You are assuming that our economy is standing still, and it is not standing still. And somehow we are going to have to move those people so that their estimates are based on what is actually happening in a moving economy rather than what would happen in a completely dead, static economy lying still in the water. Otherwise we will continue to have taxes so high that they stifle the very growth you are hoping to bring about. The tax provisions lose revenue to the Government, and yet Treasury estimates coming in here indicate that if you try to do something about them it is going to cost the Government a fortune when, in fact, it would probably create additional revenue for the Government.

So far, just on the capital gains alone, we have not been able to get the administration to bring in an estimate that looks at the kind of data that they looked at in 1963 when President Kennedy sent his recommendation up and indicated that you would have induced effects that would pick up $650 million. I could not find a dollar out there today of the $650 million that President Kennedy had.

Somehow, we are going to have to get people to see some of the errors of their ways. I am not saying that Dr. Norman Ture is correct about everything, Mr. Bixler, because I know that he has made his mistakes, just like all the rest of us, from time to time.

I am saying on this point that those of you in the business community are going to have to convince the people in the Treasury that they are just as wrong as they can be. I do not know how you are going to do that except by getting a lot of economic support, and also by getting some solid business people, bankers and others, to help point out to Treasury that they are back in the dark ages with their revenue estimates, by not taking into account the dynamics of this economy.

Mr. CARLSON. Senator Long, may I make a comment?

I was particularly discouraged with the Secretary's testimony when he said estimates for particular tax changes do not include feedback effects. There is no attempt to even try to measure it, which puts us even further into the dark ages than if we had arguments about what the feedback effects would be, and clearly no one in this world who has had any background at all will say that when you lower the cost of capital, you are going to invest less in capital, not more. All the data shows you are going to invest more.

The argument should really be on what the magnitude of how much more investment and job creation comes from it, not that there will not be any.

The CHAIRMAN. I hate to say this about our friends in the Treasury—in fact I do not like to say it about any Government agency—but when it is true, I think it is our duty to say it. They are demonstrating the same old bureaucratic tendency to place a ridiculously low revenue estimate on something that they themselves generate, and to place a ridiculously high estimate on something that someone else generates.

If they had thought of the capital gains cut first, if they had put it in the administration package, my guess is they would have found even more feedback than President Kennedy found in his proposal. But since it is somebody else's idea, they will wander around in the dark forever and not be able to find that feedback.

Maybe with your help, though, and with the help of others who have served in some capacity, we can get them to change their attitude of assuming that a tax cut will not work—because basically that is what you are doing when you are assuming that there is no feedback, no beneficial effect to be generated by what you are doing, that you are only cutting taxes, for example, to help a rich man or a poor man, whoever gets the first bite of that dollar. That assumption has got to be an error.

Mr. BIXLER. On table 5 of page 9 on my statement, there is very fresh material on what would be the result if we were to reduce the bottom rate to 17 percent and the top rate to 45 percent, a reduction of three points.

The astounding thing to me is that, in the very first year, there would be an increase of Federal revenue of $1 billion as against the estimated deficit of $8.2 billion in the static predictions that were made previously.

At the same time, this change alone would account for $18 billion increase in the gross national product in the business sector and in-

crease domestic nonresidential investment by $9 billion. Is that not the very thing we have been talking about?

The CHAIRMAN. Right. Thank you, gentlemen.

Senator Danforth?

Senator DANFORTH. One of the problems with trying to advocate business tax cuts is that it is viewed by the press and by a lot of people as being probusiness, antipeople.

President Carter, in his economic report in January, stated that over a broad expanse of years, improvements of the standard of living in this Nation depends primarily on growth in the productivity of the American work force. He went on to tie productivity to investment.

Therefore, his position was that the standard of living of people was tied to productivity and to capital formation.

Now, over the last decade, in productivity the United States has ranked, obviously, behind Japan and West Germany, also behind France, behind Italy; tied with Great Britain.

In capital formation as a percent of gross national product, the United States has ranked last among the industrialized countries, well behind France, Italy, the United Kingdom. I do not think many of us would view them as exactly economically strong countries right now.

Now, my questions to you are two. One, is it reasonable to link the standard of living of the people in this country to productivity and capital formation; and two, would a tax reduction phased over 5 years, clearly within the budget resolution, phased over 5 years so that by 1983 it gets down to a maximum corporate rate of 42 percent, be a significant stimulus for increased productivity and capital formation?

Mr. BIXLER. In my opinion, the answer to both questions is yes. Certainly productivity depends, in part, on investment in facilities and equipment and also in research and development. These all finally have the effect of making it possible to pay higher wages and have a higher standard of living.

On the other question about a definite phased-in further reduction of the corporate rate as an important factor in business planning, in various small corporations in which I operate it would indeed be important. I serve on the board of some larger institutions, and I am sure that there, in particular, that kind of predictability is very important.

We have said in times past it is so important to make the investment credit permanent. That is one of the good things that is being done in the bill before you now. This is important because you do not make these investment decisions overnight. You do not spend money just for the sake of spending it.

Senator DANFORTH. I would hope that you can share my view that the bill that is before us now is inadequate for the purposes we are talking about.

Mr. BIXLER. I described it as a good first step, but inadequate in the long run is more accurate.

Mr. CLARFIELD. To the first question you raised, there is no question that productivity is dependent on capital formation. I think we all agree with that.

On the second question, I am not sure what you mean by tax reduction. If you are talking about tax reduction for that segment of the economy that would consume more, then I would say——

Senator DANFORTH. Reduction in corporate rates.

Mr. CLARFIELD. Absolutely. No question. I agree with you.

Mr. CARLSON. If you would turn to page 7, and subsequently to page 9, it reinforces exactly what you said on a comparison across countries, in terms of the U.S. experience.

As you will notice in the U.S. experience, investment growth after adjusting for inflation was about 3 percent until 1973. Since 1973, the annual growth rate has been 1.1 percent. The capital per labor hour consequently has gone down. Consequently, productivity growth has gone down.

And notice that real wages have actually declined, and that is where you get to your standard of living. Standard of living is growing less rapidly and is, in fact, negative in many sections of our community because we do not have the investment growth.

If I could finish the point, on page 9, if you will look at the different proposals to encourage investment, the investment tax credit, capital gains and the corporate rate, you see in line 4 where a family income does go up for every $1 billion of investment you make after 4 years.

Senator DANFORTH. Thank you.

Senator MOYNIHAN. Senator Packwood?

Senator PACKWOOD. Dr. Carlson, on page 16 of your statement, you make reference to a capital gains tax relief cut of $2 billion. I am not sure what you mean by $2 billion. All the estimates that we had showed an increase in revenues for adoption by the Steiger-Hansen capital gains tax.

What is you $2 billion figure?

Mr. CARLSON. The $2 billion was accepting the static approach of the Treasury, and some estimates have been a little over $2 billion, others after 4 years have been as high as $3 billion.

We did mean the Hansen-Steiger bill.

Senator PACKWOOD. You are projecting, then, not the Merrill Lynch's or Dr. Ture's or Data Resources estimates in the future that we will not lose money on that in the first year?

Mr. CARLSON. We fully expect that you are going to have an increase of capacity and you are going to have an increase in jobs and people are going to pay taxes on those jobs, and the increased return on investment. So some of the loss you receive initially will certainly be recovered in the near term.

I think the extent of the argument we have in this country is whether you recover all of it and how soon, and I do not think you even need to face whether you recover it at all. The fact that you will recover some and it stimulates the economy and raises the standard of living to justify going ahead with it.

Senator PACKWOOD. Those four studies we had projected an increase in capital gains receipts even in the first year because of the presumption that a great number of people are going to sell stock that they have had for a long period of time immediately. Maybe this is under the theory the capital gains tax will not remain low very long, and they had better get out now. They do not even project a loss at all from the start.

Mr. CARLSON. I understand it. That is the one stimulus that would have the unlocking provision more than some of the others. It is awfully hard to estimate.

You could well recover your revenues within the first year.

I do not need to accept that as likely to happen to still justify support for the Hansen-Steiger bill.

Senator PACKWOOD. I wanted to be sure that your $2 billion figure was more like the Treasury's static estimate, rather than any estimate taking into effect the effects of capital gains reductions.

Mr. CARLSON. Yes, sir.

Senator PACKWOOD. I have no further questions.

Senator MOYNIHAN. Thank you, Senator.

Senator Curtis?

Senator CURTIS. In the statement of the NAM, you made reference to a pickup of $1 billion in revenue where another estimate had been an $8 billion loss. What item was that?

Mr. BIXLER. That is in net Federal revenue as is shown on table 5 of page 9 of the Ture appendix.

Senator CURTIS. What tax was it?

Mr. BIXLER. Reducing the corporate rate by 3 percent, making the normal tax rate to 17 percent and the normal tax and surtax together 45 percent, as against the 20 percent and 48 percent figures currently.

Senator CURTIS. Your figures are accounted for through a stimulus to business or a different application of the formula?

Mr. BIXLER. Essentially these figures result from the supply side effects, not assuming that everything is going to be consumed but that part is saved, and reinvested. This is, of course, based upon some historical perspective as well. But the Ture-TIP model that I describe enables us to say that if you made this particular tax change, or that particular one, then you do have to see only the total effect of the bill you have before you. These figures simply reflect a different change in the corporate rate from what the bill now says.

Senator CURTIS. That is the reason I asked you what tax you were referring to. I knew that you did not intend to use those figures with respect to the total bill.

Mr. BIXLER. The other thing, Senator, that I should point out, this also assumes that we would set the surtax exemption at $100,000 instead of $50,000 as it is now. In the bill before you, there are four graduated rate steps: $25,000, $50,000, $75,000, and then $100,000.

Under the figures that we have just been talking about, we would tax all corporate income up to $100,000 at 17 percent and everything above that would be taxed at 45 percent, and this is a result if that change were made.

Senator CURTIS. That would increase revenue?

Mr. BIXLER. It would. That is what the last line indicates.

Senator CURTIS. I would like to ask each of you this question. What would be the effect in revenue if we reduced capital gains rates, if we moved capital gains from the minimum tax and had an absolute ceiling on capital gains of 25 percent, what would be the effect on revenue?

Mr. Carlson?

Mr. CARLSON. To move to that condition, we do not have a lot of experience. We did have the experience in 1969, although that is not conclusive, moving in the opposite direction.

Clearly, you are going to have an increase in revenues because of that move, and when and if it recovers the entire tax loss immediately is the question in dispute.

Clearly the evidence shows it is going to recover 50 percent of it. I do not think anybody is arguing, or should be arguing—the data is fairly strong there. Whether it recovers 100 percent of it or not is more speculation because our historical data base is not that good to say precisely what would happen, in my view.

Senator CURTIS. What you are saying is there might be a little delay, but after that delay there would be a revenue increase?

Mr. CARLSON. Clearly, the revenue return, the feedback on additional revenues, once the initial tax reduction occurs, will increase with time. No question about that.

Senator CURTIS. Increase over the present?

Mr. CARLSON. If you made no change in terms of whether you get 100 percent back of your revenue loss—I cannot prove it to you with historical data. Some people can tell you that some of the past experience would show that you get more than 100 percent of your initial tax relief. I feel very comfortable with making a very strong case that you would recover at least 50 percent in the very near term.

Beyond that, I do not have an awful lot of historical data to be positive.

Senator CURTIS. Mr. Clarfield?

Mr. CLARFIELD. Senator, if we believe that this economy has capital constraint—and I certainly believe that—not taxing, or reducing the tax on capital gains will clearly keep the stock of capital that much higher. That, in turn, will produce additional revenue. I am not an economist and I cannot quantify it, but I think it is perfectly clear that revenue will increase because of additional capital, if we assume we are capital constrained.

I think that just follows.

Senator CURTIS. Mr. Bixler, what is your answer?

Mr. BIXLER. On the Hansen-Steiger proposal, we did run that through the Ture-TIP model and we came out with these numbers. Hansen-Steiger is essentially the same proposal you asked me about.

The net revenue feedback in the first year alone would be a $3 billion gain.

Senator CURTIS. A $3 billion increase in revenue?

Mr. BIXLER. Yes, sir, and $1 billion in 1980, taking into the account the fact that some gains that are locked in would be turned over in the first year.

Senator CURTIS. It seems to me that so far as our private enterprise economy is concerned, that right now we are in a position that can be illustrated very clearly with an example in agriculture.

I heard of a man who said he would not spend any money for fertilizer until he had his mortgage paid. In all probability, he will never get that mortgage paid, and I am impressed by your statement, particularly those figures you cited, Mr. Bixler, about the capital gains. A young man who was born and educated in Nebraska came into my office awhile back. He had gone into a particular branch of electronics manufacturing on the west coast. He employs about 200 to 300 people. He needed money for his factory.

Every place he went in the United States he was turned down, and they gave as a reason the capital gains tax, including its inclusion in the minimum tax.

As a result, he either had to throw in the towel or get foreign capital, and today the Japanese have financed his operations. They have no capital gains tax.

So that I am sure that in that situation alone, the Federal Government, wanting the revenue directly, plus the other effects on our trading and so on.

There are many other things I would like to comment on, but I will not take any more time.

Senator MOYNIHAN. Thank you, Senator Curtis.

Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

I would like, gentlemen, to raise two points and then have your comments.

No. 1, I think it is very important that we understand today that we have an opportunity to change the direction of this country, that we are not just talking about a 1-year tax cut; that we have an opportunity to move in a new direction of freeing up the private sector.

I think it is important that we recognize the reason this is the case, the reason we are not talking about egalitarian measures as we usually do in this committee. The fact is that the American people are involved in a tax revolt.

So my first point, gentlemen, I think that whatever we do here we must send a signal that we are making a long-term change in the direction of the country. By a long-term change, I mean we are making a commitment to the American people and to the private sector that we are going to enable them to retain, keep, more of their earnings.

The only reason I think we can be talking about changes in capital gains and some of these other important measures for capital formation is because of the mood of the American people.

What I am proposing in our legislation is that we leapfrog the big spenders. The big spenders make commitments every year for increased spending, and what I seek to do through the Roth-Kemp legislation is to make a long-term commitment to free up the private sector, and we are going to permit our American people to keep more of their own earnings, to enjoy the benefits of their labors, and to give them some incentive to work and to save.

The only way you are going to move in a new direction and hold down the growth of spending, as I say, is to leapfrog the commitments that have been made in the past and are being made this year in spending.

That brings me to my other point. The administration, in trying to fight any massive tax cut for the American people, are arguing that it is inflationary. For the reasons I just said, I think the Roth-Kemp is anti-inflationary because by committing revenue to the American people, you are going to force the growth of Government to be held down, force some discipline, force some efficiency to be moved into the Government.

The other point I would like to make is that the administration's own proposal—which really is just a rehash of what they do every year, or what we have been doing for the last 10 or 15 years—is inflationary. It is inflationary because their tax proposals are income transfers and only deal with demand. It has nothing to do with promoting savings or capital formation.

It is a smokescreen when they attack these other approaches, when their own proposal is really just a continuation of the past, and inflationary in effect because it does nothing on the supply side, but only demand.

I wonder if you gentlemen would care to comment on this?

Mr. BIXLER. I would be happy to.

Certainly on the point of looking ahead and making a commitment on which people can plan, I have already commented this morning that that is a very advantageous thing. To the extent it preempts Federal spending, certainly it is also highly desirable.

As you pointed out, there may be some discussion as to what are the specific rates and the mix in the package. Speaking only personally, I have the feeling that in the Roth-Kemp proposal, there is too much weight to individual changes and not enough to corporate changes, for example. The corporate change in part is to get that extra manufacturing capacity.

Senator ROTH. Let me point out by returning the rate from 70 to 50 percent, you are achieving the old rate for capital gains, except for the so-called minimum.

Would the other two gentlemen comment?

Mr. CARLSON. Yes.

I would have to endorse what you say. Clearly, the budget authority number is going up so rapidly it means we have a bow wave effect on spending in 1980–81. If one is going to control the budget in future years, you had better start now.

I agree 100 percent with looking at this spending side and not just the tax relief side, so we make sure that deficit is trending down and do not have demand-pull inflation.

Also, I might say we have an awful lot of cost-push policies passed by the Congress and administration—increases in minimum wage, increase in social security taxes, increase in regulations, all of those adding up to 2 percentage points add-on to the inflation rate this year.

Some of the policies are causing the inflation, as well as the spending leading to high deficits, causing demand pull type inflationary forces that we have to treat too.

Mr. CLARFIELD. I would agree that any device that is successful in reducing Government spending will be beneficial to the economy. I agree with Mr. Bixler that certainly tax cuts should be in the area that tend to create capital rather than tend to encourage consumption.

Senator ROTH. In closing, I would like to emphasize that these tax proposals are only possible today, in my judgment, because the American people perceive a need for something being done. I was happy to see that at least some of you, in your comments, understand and appreciate the importance of these tax cuts. You can argue the mix, but these tax cuts must be shared by the American people so that we can make a long-term change in the direction of our economy.

Thank you, Mr. Chairman.

Mr. BIXLER. If I could add one last comment, in advocating the 3-percent corporate rate reduction, I was speaking about the bill immediately before you for a reduction the year 1979. I did not mean to imply, for example, that the 6-percent-phased-in reduction that Senator Danforth suggested was something we were against. We do encourage this.

Senator ROTH. I think that is a part of the Roth-Kemp intent, to make a commitment now for the future.

Senator MOYNIHAN. Senator Hansen?

Senator HANSEN. Mr. Chairman, I appreciate the testimony and the responses. I have no questions.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Thank you, Mr. Chairman. I would like to make a very short speech in the form of a question.

To you gentlemen, I say I am not an economist and make no claims in this field. I am struck with one thing, which is the degree to which, first of all, you address the question, and interest this side of this committee. On the question of productivity and the question of investment, you put before us a sort of rationalistic model of what will affect these patterns, and I do not think I am entirely persuaded of it.

When Senator Danforth spoke about the lag in investment as a portion of GNP, this has not occurred in just the last 10 years, it has occurred over the last generation. If you plot investment and GNP against productivity, we come out the lowest country in the OECD since 1948, and one wonders why. This cannot be described as a result of one set of tax policies, or one Administration, or even three.

One wonders if you are not making promises that you are going to have difficulty keeping, and do you know how much is in the promises that you are making?

I put it to you. It cannot just be because of tax policy that the steel industry fell behind that of Japan in the sixties. It has to have something to do with the Dusquesne Club, if you know what I mean.

There is a culture out there in the industry. Once it was an industry that roared ahead, and then it became an industry that fell behind.

Are you satisfied you are not overpromising?

Mr. BIXLER. Actually, do you not think that one of the factors there would be the damage from World War II? In a sense, when things were badly damaged or completely destroyed, you had to start out completely new.

Senator MOYNIHAN. It is a pretty subtle argument. It says we blew your industry to bits, therefore, inevitably, you overtook us.

Mr. BIXLER. I agree, but I think the wartime effects may be one part of it. I think there are a whole series of questions about Government subsidy—for example, the steel industry in Japan is subsidized highly on the cost of fuel for power, and that is an important element in the whole thing that has not happened here. It seems to me that this is a very complex question.

Senator MOYNIHAN. Output per man hour rose above the United States in the late sixties. That is the true measurement.

Mr. CARLSON. Is is true, Senator Moynihan, there are other factors. The physical gap may only account for a half a percent. Human capital, which you have been involved in very much over your life, is part of it, too.

Senator MOYNIHAN. Are you not sure you are giving us too rationalist a mode?

Mr. CARLSON. The best data we have involve lowering the price of a commodity and finding out how people respond to it. If you lower the cost of capital—the cost of capital has gone up considerably the last few years—you are going to have a response.

That is the best data we have, so we know we are going to get a response. Now you can argue how big the response is. That is how the debate should be. The debate should not be that there is no response.

Senator MOYNIHAN. Let me be fair. I think it is the best data we have, and we are very much disposed to respond to it, but I would like to discuss it a little.

Mr. CLARFIELD. I work for a large company that is quite capital-intensive and we are capital constrained. If we received a bigger investment credit, a lower tax rate, we would have more money and we would spend it. We would spend it on capital projects.

Senator MOYNIHAN. Thank you.

Mr. CARLSON. May I add, Mr. Chairman, we did take a survey of American business. Fifty percent of them said that they would increase their investment if the cost of capital were lowered in the ways that we are discussing before this committee, so if business intentions surveys mean something—and I think they do—there is an indication that we could have some improvement.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Thank you.

I am pleased to see that the State of Connecticut is well-represented on this panel, here.

One question: What should be left out of this bill, or added to this bill, to achieve the following: An increased rate of productivity; lowered inflationary pressures; increased exports; and strengthening of the dollar?

Mr. BIXLER. I suggested first to change the corporate rate to make the bottom note 17 percent and the tax rate 45 percent. That would mean a reduction of three percentage points both at the bottom and at the top.

In addition to that, there might well be some study of capital gains as far as business is concerned. The bill before you makes very little provision there.

Those are the two principal changes that occur to me.

Mr. CLARFIELD. On the question of productivity, we think that a reduction in taxes in the bill in those areas which tend to be most beneficial, the inflation question that you ask, I think, is more related to a spending bill than to a tax bill. You can argue that the other way around, but right now we are discussing the tax bill.

We think that the creation and enhancement of capital is what this country really needs. We think that will help in the export area, too.

As to exports specifically, something that is not in the bill and we think should not be—that is the repeal of DISC. We mention that because it is likely to come up later. We think that now is not the time to tamper with something like that.

I do not want to rehash these arguments that have been made many times before, but we think it is a beneficial provision and, in addition, being a beneficial provision as far as exports are concerned, it generates capital for businessmen and that capital does for us, I know, and that capital is being spent on capital formation projects.

Mr. CARLSON. Senator Ribicoff, clearly any of the investment items are going to increase your capacity and thereby give you some relief from demand-pull type inflation. A lot of people—more people will be employed because you will have more tools for them to work with.

Any of the investment-enchancing proposals will do that: going to the full Hansen bill on capital gains from where you are with the House bill, a corporate rate reduction of a percent or two below the Jones bill, the investment tax credit being given to structures without limitation on liability and something you are not talking about doing something with, the depreciation allowance.

Depreciation is $17 billion short of recovery of replacement costs and driving up the cost of capital considerably. You are not talking about that particular item, but you are talking about the other three.

Those things will tend to lower your cost of capital and make you somewhat more competitive with those abroad and help to improve your chances of increasing your exports.

Senator RIBICOFF. What bothers me is the Japanese rate of productivity increases annually in the neighborhood of 8 percent. West Germany has a 6-percent rate. The United States today is at zero.

No matter what we do with currency or devaluation or any policy, you are never going to reach Japan or West Germany or even compete with them as long as you are up against that variable in the rate of productivity.

I think the key to everything is what can we do to increase our productivity?

Mr. BIXLER. We can make savings and investment more attractive. One point that Mr. Carlson made referred to depreciation reform. I would like to use the phrase "capital cost recovery." That is one of the things that is so bothersome. When you make a commitment to a program and before you have written off the asset, the new one costs substantially more. You just continue getting behind in that way.

Both the nations you mentioned do a substantially better job of saving than we do, also. In other words, they are creating the capital to invest, to increase productivity, which in turn makes them so strong, both at home and in their export markets.

Mr. CLARFIELD. I think it might be a little simplistic to argue that all quesstions of productivity have their answer in tax legislation. There are a lot of things about productivity that I do not think this committee wants to get into now, but it is a question of worker ethic, question of available capital. It is a question of relationships among people. and I do not think that it is going to be all solved by tax reform or tax legislation—pardon the word "reform."

Certainly, there is a lot to be said in favor of enhancing the creation of capital. That is certainly one aspect. But to argue that is going to solve all the problems of the world would be insulting to everybody.

Senator RIBICOFF. If I might make one comment, Mr. Chairman, you are absolutely correct. It has to be across the span of what you mentioned. But, right now, we have before us a tax bill. So, to the fullest extent, if we can use this tax bill as an instrument to increase the rate of productivity, we ought to try.

If we have the jurisdiction for the others, it would be fine, but we just do not happen to have it. We should try to use this instrument, Mr. Chairman.

The CHAIRMAN. Let me thank you for your testimony here this morning. If we had the time, every Senator here would learn something and would enjoy interrogating this panel at greater length. I know I would, in particular.

Unfortunately, you realize we are working against the clock, and we hope to move this bill, but I assure you that I will, and I think most of us will, carefully study every word that you have brought us here, and we are grateful to you for some very fine information.

Senator ROTH. Mr. Chairman, if you would yield, for one question. On the House side, the national chamber urged Members of Congress to support the substantial tax relief contained in the Ways and Means Committee plus individual tax relief along the lines of Roth-Kemp. Is that the position of the chamber?

Mr. CARLSON. Yes, sir.

Senator ROTH. Thank you, Mr. Chairman.

[The prepared statements of Messrs. Bixler,[1] Clarfield, and Carlson follow:]

STATEMENT BY ROLAND M. BIXLER ON BEHALF THE NATIONAL ASSOCIATION OF MANUFACTURERS

SUMMARY

This statement makes the following points with regard to general tax proposals, particularly those contained in H.R. 13511:

1. There is a need for general tax reductions to offset at least partially the effects of inflation in recent years and of the coming Social Security tax hikes. A package of up to $25 billion, with approximately ⅕ for business tax reductions, would be appropriate.

2. The emphasis placed on corporate rate reduction by the Administration and by HR 13511 is highly desirable. A 3 percentage point cut, coupled with an increase in the corporate surtax exemption for small and growing firms, would be appropriate.

The graduated corporate rate structure contained in HR 13511 would introduce the "taxflation" problem to the corporate tax system and result in increased clamor for rate bracket adjustments in future years. A combined rate cut and surtax exemption approach is preferable.

4. The liberalizations of the investment tax credit in HR 13511 are desirable. The permanent 10% rate and the 90% income tax liability limitation will enhance the stability and usefulness of the credit.

5. The "reforms" proposed earlier this year by the Administration, such as those affecting "deferral" and DISC, should not be adopted.

INTRODUCTION

My name is Roland M. Bixler, and I am President of J-B-T Instruments Inc., of New Haven, Connecticut. I represent the National Association of Manufacturers as a member of its Board of Directors and as Chairman of its Committee on Taxation.

The NAM represents 12,400 member firms which employ a majority of the country's industrial labor force and which produce over 75% of the nation's manufactured goods. The Association also represcents 125,000 firms affiliated with the NAM through the National Industrial Council. Over 80% of the NAM's members are generally classified as small businesses. I am a small businessman myself, as an owner of an electronics manufacturing firm employing fewer than 100 persons.

The Committee's announcement for these hearings requested that witnesses not duplicate testimony on a number of issues which have been the subject of other hearings. We have adhered to this request as closely as possible. However, there are portions of this statement and the appendices submitted for the Committee record which are related to the tax reduction proposals and capital gains issues which have been outlined previously before this Committee.

OVERVIEW

The NAM supports a general tax reduction for both individuals and corporations, improvements in the investment tax credit and a reduction in the taxes on capital gains. These reductions should be made without the offsetting tax increases which often are proposed under the label of "tax reforms."

[1] Additional comments of Mr. Bixler appear on p. 547.

The bill adopted by the House, HR 13511, is a significant step in the right direction and can serve as the foundation for an even better package. NAM has favored a somewhat larger total tax cut. The corporate rate cut in particular should be increased. In addition, NAM strongly favors a two tier corporate rate rather than the series of graduated steps currently included in the bill.

The NAM strongly advocates the use of econometric analysis for measuring the overall economic effects and *net revenue* impact of tax proposals such as HR 13511 and others before this Committee. Four years ago this month, we launched NAM's Tax Impact Project (TIP) to develop the capability to move beyond the static revenue estimate by which tax proposals had been judged traditionally. This statement includes an extensive appendix which sets forth this type of "feedback" analysis as provided by the Ture/TIP model, developed by Norman B. Ture, Inc., of Washington, D.C., with sponsorship by TIP. We appreciate the interest in and support of this type of analysis expressed by Chairman Long and other members of the Committee.

TAX REDUCTIONS IN GENERAL

Earlier this year, NAM expressed general support for the Administration's overall proposal for a $25 billion net tax reduction to ease the impact of inflation on individual tax brackets, on business depreciation allowances, and on capital gains and other items. "Taxflation"—or the increase in real taxes due to taxes on inflation-generated income—has become a significant problem for all taxpayers. General tax cuts are desirable to reduce this impact and to ease the shock of forthcoming Social Security tax increases.

One potential problem with a very large tax reduction is its impact on the federal deficit and inflation. While a large tax reduction can and should be offset by spending reductions, the impact on the deficit can also be eased noticeably by a well reasoned mix of reductions within the package. All tax reductions do not affect all taxpayers in the same way, so they do not produce the same kind of economic effects.

With differing economic effects, the *net* revenue impact on the federal Treasury will also vary, as shown in the Ture/TIP analysis of HR 13511. For example, the corporate income tax rate in general has a greater impact on the level of investment than does the individual tax rates and a larger feedback effect on net revenues. The static revenue estimates for components of HR 13511 are contained in Appendix A. The calendar 1979 revenue estimates indicate about an $11.9 billion loss due to individual rate and bracket changes, repeal of the general tax credit and a higher personal exemption. There is about a $5.1 billion loss due to corporate rate reductions. While the static revenue estimate for these individual changes is a little more than 230% of that for the corporate rate change, the Ture/TIP analysis (see Appendix B, Tables 2 and 4) indicates that they would generate only approximately 162% as much non-residential investment while causing 400% of the revenue loss attributable to the corporate cut in the first year. (The explanation of such varying results as set forth in the text of Appendix B.)

What this suggests is that a significant portion of the general tax cut should be provided to the corporate sector, particularly since new business investment is needed and the deficit needs to be restrained. Providing one-third of the package to business would be desirable.

BUSINESS TAX REDUCTIONS

The desirability of corporate rate reductions

For many years, the business community has supported the across-the-board rate reduction as the simplest, most equitable and most stable form of tax cut. NAM applauds the Administration's emphasis in this area, and we urge this Committee to adopt general rate cuts as the centerpiece for HR 13511.

Simplicity.—There is little doubt that a reduction in the corporate tax rate is a simpler and more readily understandable form of business tax cut than other changes, particularly for the owner/manager of a smaller firm who does not have a separate tax staff to decipher complex statutory and regulatory language. Even for major corporations, the implications of rate cuts are more readily understood and taken into account by senior management.

Equity.—As an approach to broad-based tax reduction, an across-the-board rate cut is the one change which has the widest application. The small firm and the large corporation, the manufacturer and the insurance firm, the heavily capital-

intensive industry and the labor-intensive retail chain—all of these companies are affected by rates. So, when a general tax reduction package is being formulated, there is no more even-handed approach than the across-the-board corporate rate cut.

Stability.—One unfortunate aspect of federal tax law in recent years has been its instability. Since 1969, Congress has passed six significant income tax bills, including major refrom acts in 1969 and 1976, and major business issues have been debated or acted upon in virtually every other bill. The early and mid-1960's were only slightly less active, with significant changes in 1962, 1964 and 1966. One impression which has developed during all this activity is that the system is not very stable overall, and this can impact investment planning. However, while the system generally has been subjected to constant change, the rate structure has been less volatile, and rate reductions are less likely to be bounced around in a few years than are other forms of tax reduction. Therefore, a corporate rate cut can both provide the expected consequences of a tax reduction and have a favorable long-term impact on business planning by providing greater stability than has been apparent in recent years.

A tax reduction of close to $25 billion would allow a larger rate cut than is provided in HR 13511. The Ture/TIP analysis indicates that a 3 percentage point rate cut, plus an increase in the current $50,000 corporate surtax exemption to $100,000, would actually produce a net revenue gain of about $1 billion in the first year with a sizable increase in total investment and GNP. (See Appendix B, Table 5.) The static revenue estimate would be approximately $8.2 billion in 1979.

The corporate surtax exemption approach

There is now a widespread recognition of the desirability of a general corporate rate cut, but there are differing views as to the specific cut which should be provided for small and growing firms. As noted above the NAM strongly endorses a two-tier structure featuring both a higher surtax exemption than the current $50,000 figure and rate cuts for all firms. In HR 13511, the House adopted a graduated corporate tax with five rate brackets along with a cut in both the top and bottom rates.

Current law.—The current corporate income tax structure includes a 22% normal tax applied to all income plus a 26% surtax applied to income above $50.000. (The normal tax currently has a small notch which taxes the first $25,000 at 20% while all income above $25,000 is taxed at 22%.) This $50,000 is the corporate surtax exemption, i.e., that amount which is not subjected to the high 48% rate. The surtax exemption is the mechanism which was intended to protect all but the very largest firms from the top corporate rate. When the two-step rate was enacted in 1950, the exemtpion was fixed at $25,000, but it was not raised to the current $50,000 until the Tax Reduction Act of 1975.

Because the exemption has not been raised sufficiently over the years, Treasury projections indicate that the number of taxable corporations with incomes above $50.000 will have more than doubled from less than 93,000 in 1969 (12% of the total) to about 195,000 in 1979 (19% of the total). Rather than protecting all but the largest firms, the exemption will allow nearly 1 out of every 5 taxable corportions to be hit by the top rate next year. (See Appendix C.)

A 3 percentage point cut with a $100,000 surtax exemption would provide a 15% tax cut for the smallest corporation with less than $25,000 of taxable income (i.e., 3/20=15%.) The same 3 point reduction for the very largest corporations would provide a noticeably smaller cut—slightly under 7% (i.e., 3/45=6.7%.) The largest percentage reductions would come at the new $100,000 exemption level where the total tax liability would fall from $34,500 to 17,000, a drop of 50%. While this would be a large cut, it would be a highly justified offset to the significant tax increases borne by such firms which have moved above the surtax exemption due in large part to inflation in recent years.

A graduated corporate rate

In HR 13511, an entirely different concept is being proposed—namely a graduated rate structure involving five rates. Unfortunately, the very term "graduation" has taken on a life of its own as the answer for small business tax relief, even though it has no such magical attribute. The comparison tax liability table in Appendix D shows that a general rate cut with a higher exemption can provide similar tax reductions to graduation at similar revenue costs. (Appendix D is a comparison based on HR 13511 as adopted by the House. Similar comparisons can be drawn for other graduation proposals.) The whole subject of

graduation should be examined, not accepted on faith. Graduation is a fundamental departure from the way corporations are taxed. The consequences and ramifications of such a departure should be seriously studied.

"Ability to pay."—In principle, graduated rates would seek to impose an "ability-to-pay" concept on corporations. While this concept may be applied somewhat rationally to individuals, corporate taxable incomes are not good measures of an "ability-to-pay." For individuals, a whole series of exemptions and deductions seek to place all individuals on roughly equal footing before applying graduated rates to their incomes above the excluded amounts. But for corporations, the tax law does not take into account differences in numbers of employees or invested capital or mandated expenses or regulated price structures. Yet, all of these are important factors in measuring an "ability-to-pay." For example, a $50,000 income might be quite high for the family-owned drug store employing 10 people, but $100,000 could be low for the small manufacturing firm which employs 200 people with $4 to $5 million in capital assets. Matching a series of rates to income levels could only result in purely arbitrary decisions. Increasing the surtax exemption would minimize the arbitrary nature of corporate rates and avoid complications in the future as firms being to seek more equity in the graduated structure.

"Taxflation."—As a practical matter, graduation would actually compound the widely recognized adverse impact of inflation on the tax structure. In so doing, it would increase the clamor for corporate tax rate adjustments. For example, a company growing at the rate of 10% per year (7% inflation plus 3% real growth) would nearly double its taxable income every 7 years. Higher inflation or better real growth would shorten this time. The result would be that a company earning just under $50,000 now would move through three rate steps—$50,000, $75,000 and $100,000—in just over 7 years under HR 13511. Just as individuals object to being pushed into the next rate bracket by inflation, small business owners subjected to graduated rates could be expected to be very noisy and persistent in demanding that the various rate brackets be altered to take into accoun the insidious impact of inflation on taxable income. With a series of steps, Congress could expect to hear annually from thousands of firms which are approaching a higher step or which have just moved into one. This problem can be minimized by maintaining only one step—the surtax exemption—and by pushing it to a much higher level so that the vast majority of firms never reach it.

The "big jump."—One argument being made to support the change in the method of corporate taxation is that the jump from the single bottom rate to the top rate (currently a 26 percentage point difference) is too big, allegedly causing small firms to perform unnatural economic acts to delay moving into the next bracket. Certainly, no one looks forward to paying a higher tax rate. However, to the extent that actions are taken by small business managers to avoid such jumps, these incidences probably would increase under a graduated structure since there would be more places at which they would need to avoid the next rate bracket and many more companies would be affected. In any event, the "big jump" argument only reinforces the point that the surtax exemption is much too low. If the exemption were raised significantly, the evils of the "big jump" could be avoided altogether by most firms.

"Spin off" subsidiaries.—Another argument being made against the surtax exemption is that a growing corporation "spins off" a subsidiary corporation in order to keep both firms under the exemption and thereby avoid the top rate. However, following the 1969 Tax Reform Act, the use of such multiple surtax exemptions by affiliated corporations (those with common owners) was phased out to end the abuse of the exemptions where one business was divided into many pieces. Creating subsidiaries to "shelter" income is not allowed, but even if it were, the same scheme could be used under graduation. As an objection to the surtax exemption, this argument should be discarded.

Corporations as tax shelters.—A third argument suggests that small corporations in general are tax shelters for high income individuals, and that a higher surtax exemption would only heighten this problem and income individuals use the corporate form to collect income at rates below their marginal rates, then take it out later as salaries when their personal rates drop or when capital gains are realized on the sale or liquidation of the business. It seems likely that small business owners in general would be surprised to learn that Congress views them as tax avoiders and that tax reductions for them only enhance the growth of tax shelters. If this argument were valid, it would also apply to graduation.

In fact, if graduation were used to lower the bottom rate beneath the 17% contained in H.R. 13511, the "sheltering" attraction of the first $25,000 of corporate income would be even greater. To avoid the tax shelter problem, Congress would have to do nothing for small firms other than to cut the basic rates. NAM does not accept the shelter argument either as a reason to do nothing or to reject the surtax exemption approach.

The need for small business tax relief is generally recognized, but the change in corporate taxation which has been adopted in HR 13511 is not a desirable one. The graduated corporate rate should be examined closely because of the problems with the principle itself and with its practical application. A general corporate rate cut with a much higher surtax exemption would provide needed tax reduction while minimizing or avoid the problems raised by graduation.

Investment tax credit

In general, the Administration's original proposals for changes in the investment tax credit (ITC) represent very constructive liberalizations which would enhance its usability and effectiveness. The changes provided in HR 13511 also make a strong move toward a more efficient and more stable credit.

Permanent 10 percent rate.—Enactment of the proposal to extend the 10% ITC rate beyond the current December 31, 1980, termination date would contribute significantly to the credit's favorable impact on total investment planning. The instability of the credit over the 16 years since it was enacted has adversely affected its effectiveness because its availability over a long period of time could never be certain. While removal of the termination date for the 10% rate would not be viewed by business as a guarantee of permanance, it would lend increased stability to the credit, thus tending to enhance its impact on business planning for capital investment.

Ninety percent tax liability limitation.—Permitting the ITC to offset 90% of income tax liability rather than the current 50% should have an immediate beneficial impact on business investment in certain sectors of the economy. The phase in to this higher limitation should be faster than is provided in HR 13511 in order to speed up the favorable impact.

In many cases, the current limitation lessens the favorable impact of the ITC by requiring the carryover of excess credits for several years after the investment is made. By increasing the limitation, more of the available credit could be used to offset taxes immediately, thereby making the credit a more effective capital recovery and business planning mechanism. The increased limitation also could simplify use of the ITC by doing away with some perhaps otherwise uneconomical leasing arrangements made only to take advantage of the credit by a flow through from the lessor. Small businesses, especially those just getting started, would be aided since their initial tax liabilities are generally low but their investments can be relatively large. The additional cash flow provided by an increase in available creedits could mean a great deal to a fledgling manufacturer.

Pollution control facilities.—The NAM strongly supports the proposal for making investments in pollution control equipment eligible for the full 10% ITC, even if a special election is made to amortize the cost of such equipment over a 60 month period. However, while this would improve the current limitation of one-half of the ITC for expenditures subject to the election, NAM has received some indication that even these combined provisions would not provided a better result in most situations than existing depreciation plus the ITC.

Rehabilitation of structures.—The potential impact of the provision of H.R. 13511 for extending the ITC to rehabilitated structures is unclear. Its purpose is to induce firms to remain in existing locations rather than to move to newly constructed plants. But a 10 percent credit for rehabilitation expenses would seem to be a rather small enticement except in very marginal situations where all other factors are equal. The targeting of such tax provisions as the ITC suggests that tax policy is an appropriate and effective means of directing capital to certain areas of the country. This is an issue which is not at all clear cut. It raises potentially serious questions about discriminatory application of tax law, and these matters should be studied.

Small business proposals

The NAM is supportive generally of the thrust of the provisions of H.R. 13511 affecting only small businesses.

Subchapter S provisions.—The bill would make three changes in Subchapter S treatment: (1) allow 15 or fewer shareholders (rather than 10) for its initial

election; (2) treat husbands and wives owning Subchapter S corporation stock, as one shareholder (rather than two) for purposes of determining whether the Subchapter S shareholder limitation has been complied with; and (3) allow a Subchapter S election to be made at any time during the first 75 days of the current taxable year (rather than the first 30 days) or at any time during the preceding taxable year (rather than the last 75 days).

Small business corporation stock.—A corporation would be permitted to issue up to $1 million of sec. 1244 stock (compared to the $500,000 limitation of present law) potentially subject to ordinary loss treatment. The maximum amount treated as an ordinary loss from the sale or exchange of sec. 1244 stock for a taxable year would increase to $50,000 ($100,000 in the case of a joint return). In addition, the requirement that the sec. 1244 stock be issued pursuant to a plan would be repealed.

Special depreciation rules.—The additional first year depreciation allowance (sec. 179) would be liberalized in three ways: (1) the 20 percent allowable deduction would be increased to 25 percent; (2) the $10,000 base amount for the cost of depreciable property would be increased to $20,000 (from $20,000 to $40,000 in the case of a joint return); and (3) the section would be applicable only to a taxpayer whose adjusted basis in depreciable assets as of the beginning of the taxable year did not exceed $1 million. There is no limit under current law regarding application of this section.

These liberalizations should remove some of the tax obstacles faced by new and growing firms which need to utilize internal capital more efficiently as well as to generate external capital. However, a general improvement in the tax climate for investment and growth by all firms would also be of significant benefit to smaller firms. In this regard, general rate reductions and depreciation reform remain top priorities for industry in general.

Product liability

One subject which might be considered in this tax bill is a short term tax proposal affecting the significant product liability problems faced by many firms. The unavailablity of product liability protection has created a very dangerous circumstance for many thousands of small businesses. NAM has received a steady stream of inquiries and please for help from smaller members who have seen their insurance premiums skyrocket or their policies terminated altogether. The prospect of "going bare" is not a happy one for such firms, but many have no other choice.

In general, the solution to this problem probably lies in general tort reform. However, the immediate problem is one of preparing to fund potential claims when insurance is unattainable or when it is attainable only with very large deductibles.

This problem can be alleviated through a tax provision which covers the prudent firm's anticipation of such expenses. An approach which we support in principle is a tax deductible reserve for potential product liability claims. Such reserves should be allowed to take the form of tax exempt trusts, and the funds should be used *only* for product liability purposes. Any other use would be subject to penalty. The deduction for product liability insurance should be continued notwithstanding the existence of such a trust.

The Administration's recent proposal for a 10 year carryback for product liability costs is a step which certainly would be helpful to some firms but it would not be a major relief measure.

BUSINESS TAX INCREASES

The need for general tax reductions is widely accepted, and the original "reform" proposals have, hopefully, lost all favor. The case for rejecting the long list of such proposals has been well documented. For the record, this statement will briefly review the arguments on two of those issues—"deferral" and DISC.

Foreign tax "deferral"

Present U.S. law generally taxes income only when received by the taxpayer, but the application of this principle to the undistributed earnings of U.S.-controlled foreign corporations is viewed by some as an aberration which allows U.S. firms to defer paying taxes on income from foreign operations. The Administration and other proponents of an end to "deferral" apparently believe that

immediate taxation would result in greater emphasis on U.S. manufacture and export to foreign markets. Such views fail to consider the reasons why investments are made abroad, the benefits to the United States resulting from such investments and the impact which a change in U.S. tax law would cause.

Two facts should be understood: (1) "deferral" is not a provision in the Internal Revenue Code which can be repealed or phased out; and (2) elimination of "deferral" would not be a tax simplification concept. In fact, ending "deferral" would require extensive additions to the Code and to Treasury regulations in an effort to replace longstanding judicial interpretations of U.S. tax law which holds that taxable income is generated only when it is realized by the taxpayer.

It is a fact that United States corporations now have substantial capital investments in foreign countries. Such investments create an extremely favorable flow of funds into the United States through dividends, interest, royalties and service feed from affiliates. Department of Commerce figures for 1975–1977 report that such sources provided $24 billion more income than was sent out as new capital. In addition to balance-of-payments income, foreign operations provide higher exports and jobs for the U.S.

A 1975 NAM-Business Roundtable survey of export-related employment in 294 firms with $29.5 billion of exports found approximately 529,000 jobs related to those exports. Approximately $13 billion or 54% of their exports went to their own foreign affiliates, suggesting that 286,000 jobs in these companies alone are tied to the firms operations overseas.

If "deferral" were ended, many firms certainly would strive to continue their foreign operations rather than lose their foreign markets and reduce their U.S. employment and exports which serve such operations. A significant increase in the level of dividend remittances to the U.S. parent, with sufficient funds loaned back to the foreign subsidiary to attempt to sustain its position in its market, would result in more tax dollars flowing into foreign government coffers through the imposition of profits remittance taxes or "wihholding" taxes when funds leave the country and less available for continued growth by the subsidiary. Since such additional taxes on foreign income would be creditable against the U.S. tax liability on the same income to prevent double taxation, the U.S. Treasury would receive very little, if any, revenue. A 1978 Arthur Andersen and Co. study which was provided to the Committee under separate cover, confirms a potential Treasury loss of $235 million if corporate behavior is changed in this way.

DISC

Proponents of repeal of DISC argue that it has had only a marginal impact on exports and that recent gains can be attributed to a variety of other factors, most notably a floating exchange rate. Yet arguments for repeal criticize DISC for both its successes and its failures. It is first argued that DISC has not appreciably enhanced exports, relative to other factors, to warrant its continuation. Yet, it is also asserted that increases in U.S .exports credited to DISC are substantial enough to raise the dollar exchange rate, thus encouraging imports and thereby substantially offsetting the benefits of DISC to the balance-of-trade. The argument is taken one step further to assert that the DISC induced increase in the value of the dollar generates more imports in labor intensive industries. This then results in a negative employment effect. Exports now account for 3.5 million jobs in the U.S. and account for more than 10 percent of U.S. GNP. Treasury declarations to the contrary, the more we export the more we invest at home, producing lower unit costs for domestic users of our capital goods as well as improved competitiveness for our exports.

It is thus in the worst interest of U.S. export industries and correspondingly in the worst interests of U.S. economic growth and employment to abandon the DISC provision at a time when U.S. goods are meeting fierce competition from both industries and governments in foreign markets and when the prospect of another massive trade deficit looms in the horizon for 1978.

INDIVIDUAL TAX REDUCTIONS

The individual tax reductions contained in HR 13511 generally are constructive steps towards reducing the tax burden on middle income taxpayers. This represents a reversal of the trend of recent tax changes which have focused relief very heavily on lower income groups while almost overlooking the middle and upper income taxpayers which bear the greatest load.

The proposed bracket widening is the type of adjustment which is needed on occasion to offset the impact of inflation. The increased standard deduction—now called the zero bracket amount—also has a desirable effect. Converting the general tax credit into a larger personal exemption is preferable to the earlier proposal of repealing the exemption and enlarging the credits. In addition, this also represents something of a move towards simplification by removing the necessity to compute both the number of exemptions and the value of the credits which can be claimed.

CAPITAL GAINS REDUCTION

The NAM filed a statement with the Subcommittee of Taxation and Debt Management on July 14, 1978, on the general subject of taxation of capital gains. We are supplementing that statement now with a few additional remarks at this time on particular features of capital gains reductions in HR 13511 and related matters which should be considered by this Committee. While supporting a general corporate rate reduction, NAM also supports a reduction in the capital gains tax rate for corporations. Most of the attention on capital gains has focused on changes affecting individuals, and this is appropriate since the matter is of primary importance to individual investors, small business owners and home-owners. However, the subject of corporate capital gains is of significant interest to some segments of industry, and we believe that the corporate capital gains rate should be reduced as part of a general rate reduction. In addition, we encourage close attention to the effective dates of capital gains changes to ensure that taxpayers do not skew their decisions or find themselves penalized unduly by their timing.

CONCLUSION

The need for a general tax reduction is generally recognized. H.R. 13511, as adopted by the House, takes a very significant step in the right direction, and it will serve as a good foundation for improvements which can be made by this Committee.

NAM encourages an increase in the overall size of the package. We support the emphasis placed on corporate rate reductions and encourage adding one more point to the general rate cut. We strongly favor an accompanying increase in the corporate surtax exemption to a rate of $100,000 rather than imposing a graduated corporate rate.

The proposed changes in the investment tax credit and capital gains would be very beneficial changes in tax policy and would improve the general tax climate for productive investments. The individual tax changes are a welcome sign that the burden of middle income taxpayers is being recognized.

We also very strongly commend to the Committee's attention the type of feedback analysis which NAM has worked to develop. This new tool can be a very important addition to the tax legislative process, and we urge the Committee to give serious study to the information contained in the appendeces of this statement.

APPENDIX B

ECONOMIC AND FEDERAL REVENUE EFFECTS OF H.R. 13511

Enactment of H.R. 13511, as passed by the House of Representatives, would have a substantial expansionary effect on the economy and would modestly increase Federal tax revenues. Assuming the effective dates of its various provisions as specified in the bill, full-time equivalent employment would be 1,250,000 greater than under present law in 1979; in 1988, the gains in employment would be about 1,830,000 (Table 1).[1]

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[1] These estimates were produced by use of the Analysis of Tax Impacts Model developed by Norman B. Ture, Inc., under contract with the National Association of Manufacturers. The Analysis of Tax Impacts Model is a dynamic, general equilibrium model, designed to identify and measure the effects of tax changes on the economy and on Federal tax revenues. The model's quations are specified in terms of neoclassical formulations of the determinants of the economic behavior of businesses and households. Tax changes are identified principally in terms of their impacts on the relative prices of personal, market-directed effort vs. leisure, of saving and capital formation vs. consumption; these impacts alter the conditions of supply of labor and capital inputs, hence aggregate real output and income. The effects of the latter changes on Federal tax revenues are measured to derive the net revenue consequences of any specified tax change.

These expansionary effects would stem primarily from the reductions in individual marginal income tax rates, the revisions of the corporate rate structure, and the change in the treatment of capital gains. The reductions in marginal individual income tax rates provided in the bill would significantly reduce the existing tax bias against market-directed personal effort. These rate reductions would contribute directly to increasing the supply of labor services and, with the changes in the tax treatment of capital gains and the corporate rate reductions, would also reduce the existing tax bias against saving and investment. The lower rates of tax on the returns to capital would increase both the supply of capital—the amount of saving—and the demand for capital facilities. The resulting increases in capital formation—$50 billion more gross private domestic investment in 1979 than projected under present law—would lead to an increase in the capital : labor ratio. This, in turn, would enhance the gain in labor's productivity, as reflected in the increases in real wage rates, and result in an increase in both the demand for and supply of labor services.

APPENDIX A: REVENUE ESTIMATES FOR H.R. 13511

TABLE 3.—REVENUE EFFECT OF H.R. 13511 BY PROVISION, CALENDAR YEARS 1979–83

[In millions of dollars]

Provision	Calendar 1979	1980	1981	1982	1983
Individual tax reductions and revisions:					
1. 6-percent bracket widening, rate cuts, and increased zero bracket amount	−10,584	−12,240	−14,180	−16,453	−19,121
2. Repeal general tax credit	10,397	10,985	11,618	12,302	13,039
$1,000 personal exemption	−11,681	−12,382	−13,125	−13,913	−14,747
3. Itemized deductions:					
(a) Repeal gasoline tax deduction	1,151	1,358	1,602	1,890	2,231
(b) Revise medical expense deduction	40	47	56	66	78
(c) Repeal political contributions deduction	6	7	8	10	11
4. Simplification of the earned income credit	−17	−16	−16	−15	−14
5. Tax certain unemployment benefits	251	161	259	263	268
Total, individual	−10,437	−11,980	−13,787	−15,850	−18,255
Business tax reductions and revisions:					
1. Cut rate on income over $100,000 from 48 to 46 percent, and tax income below $100,000 as follows: 0 to $25,000, at 17 percent; $25,000 to $50,000, at 20 percent; $50,000 to $75,000, at 40 percent; and $75,000 to $100,000, at 40 percent	−5,069	−5,551	−6,078	−6,655	−7,288
2. Increase investment credit limitation to 90 percent (phase in over 4 years)	−287	−629	−1,169	−826	−728
10-percent credit for pollution control facilities	−8	−25	−53	−91	−112
10-percent credit for rehabilitation expenditures	−237	−276	−300	−328	−355
3. Repeal general jobs credit	2,458	2,458	2,458	2,458	2,458
Targeted jobs credit	−523	−718	−772	−855	−900
4. $10,000,000 limitation on capital expenditure for industrial development bonds	−2	−10	−18	−26	−34
5. Small business provisions	−379	−322	−277	−242	−216
6. Tax shelter provisions	14	10	8	5	6
Total, business	−4,033	−5,063	−6,201	−6,560	−7,169
Capital gains tax provisions:					
Individual:					
1. Repeal alternative tax	133	143	154	166	178
2. Remove capital gains from preferences	−1,327	−1,459	−1,605	−1,766	−1,942
3. Exclude capital gains from sale of a principal residence	−745	−820	−901	−992	−1,091
4. Alternative minimum tax on capital gains	172	190	209	230	253
5. Index basis of certain capital asset		−409	−1,396	−2,082	−2,805
Corporate:					
6. Remove capital gains from preferences	−95	−104	−114	−125	−137
7. Index basis of certain capital assets		−129	−426	−755	−1,225
Total, capital gains	−1,862	−2,588	−4,079	−5,344	−6,769
Grand total	−16,332	−19,631	−24,067	−27,754	−32,193

Source: Report of the Ways and Means Committee on H.R. 13511, H. Rept. No. 95–1445, Aug. 4, 1978, pp. 18–19.

The large increases in labor and capital inputs in the private sector shown in Table 1 would result in material gains in real GNP. Measured in constant 1977 dollars, GNP in 1979 would be $101 billion more than under present tax provisions; in 10 years time, the increase in real GNP would grow to $222 billion.

The gains in employment, real wage rates, capital, real output, and income shown in Table I would significantly expand the bases of most Federal taxes. As a result, Federal tax revenues would be modestly greater than projected under present law.

The effects of the principal individual income tax changes proposed in H.R. 13511 are shown in Table 2. These effects show both the work and saving responses to the substantial reductions in marginal tax rates resulting from these provisions of the bill; they do not take account of any of the bill's other provisions.

The 6 percent widening of all rate brackets and the $250 increase in the personal exemption interact to produce a significant reduction in marginal tax rates applicable to most taxpayers. The increase in the personal exemption, in itself, puts most individual taxpayers into a lower rate bracket, and the widening of each bracket is equivalent to reducing the marginal rates on the bracket into which the taxpayer moves.

The combined effect on marginal rates substantially reduces the cost of work compared with other uses of one's time, increasing the amount of labor services that will be supplied at any given pretax wage rate. To be sure, the resulting increase in labor income tends to reduce the amount of labor services that will be offered, but the net effect of the opposing price and income effects is a significant increase in the supply of labor services.

The same marginal rate reductions also significantly reduce the cost of saving compared with consumption. In practice, this means that people will want to save more of their incomes at any given pretax rate of return, resulting in a reduction in the overall cost of capital, hence an increase in capital formation. Taken by itself, the saving-investment response would result in an increase in the capital/labor ratio, raising productivity and the real wage rate. In turn, this would result in increase in both the demand for and supply of labor services.

The increases in employment and in capital produced by this package of individual tax changes would result in the substantial increases in GNP shown in the table and in the Federal tax bases. The expansion of the tax bases tends to offset in part the revenue loss from the reduction in marginal tax rates and the increase in the personal exemption. A substantial part of the offsetting revenue gain in this package, however, is provided by the repeal of the general tax credit. Since this credit, obviously, has no effect on marginal tax rates, hence cannot affect the relative costs of saving and effort, its repeal would have only a minimal effect on economic activity. It would, however, produce a significant revenue gain, reducing the overall revenue cost of the principal individual tax provisions in the bill to the relatively small amounts shown in Table 2.

A major innovation in H.R. 13511 is the provision, proposed by Representative William Archer, for adjusting the bases of capital assets to reflect inflation for purposes of determining the gain realized on the sale or other disposition of the assets. As shown in Table 3, this inflation adjustment would have a substantial expansionary effect; moreover, it would actually increase Federal tax revenues compared with projected present law amounts.

The proposed inflation indexing of capital gains would materially reduce the marginal rate of tax on capital gains. This would have a significant effect on the potential after-tax return on virtually all capital with a relatively small direct reduction in tax revenues. The resulting increases in capital formation would enhance labor productivity and real wage rates, generating an increase in both the demand for the supply of labor. The increase in Federal tax bases asociated with the increase in GNP would have a significant feedback effect on tax revenues, resulting in substantial revenue gains.

H.R. 13511 provides for a restructuring of and a modest reduction in the corporation income tax rates. This would directly increase both the demand for capital services and the amount of saving out of any given income level. The additional investment would increase the capital/labor ratio and labor's productivity, resulting in an increase in the demand for labor services. At the enhanced real wage rate, an increase in the supply of labor services would be forthcoming.

With the increases in labor and capital inputs, real GNP would expand above amounts projected under present law, as shown in Table 4. This would directly enlarge Federal tax bases, providing additional tax revenues which would largely replace the revenues lost from the rate restructuring and reduction. In addition, these tax reductions would tend to increase the proportion of total business capital and returns to capital in the corporate sector. Since even with the proposed reduced rates the overall rate of tax on capital income is higher in the corporate than in the unincorporated sector, this change in the allocation of capital would tend to raise total tax liabilities.

Reducing the corporate income tax rates, moreover, tends to change the composition of corporate-held capital from relatively short-lived facilities toward longer-lived structures. The consequence of this is a decrease in the ratio of depreciation deductions for tax purposes to gross capital income, contributing to increases in tax liabilities per dollar of gross capital income.

A further source of revenue feedback is the increase in dividend distributions and in individual income tax liabilities thereupon, resulting from the increase in corporate cash flow.

The overall effect is to reduce the revenue loss from corporate rate reductions, in this range of cuts, to very small amounts. Measured in constant 1977 dollars, the revenue loss is on the order of magnitude of $1 billion during the first five years after the tax reduction, in later years, revenues would be virtually unchanged from amounts projected under present law.

The effects of an alternative corporate rate restructuring and reduction, which increases the surtax exemption to $100,000, reduces the normal rate to 17 percent, and increases the surtax rate from the present 26 percent to 28 percent, would be about 60 percent greater than those of the rate revisions in H.R. 13511. Moreover, this alternative set of changes in the corporate income tax would result in modest Federal tax revenue gains compared with present-law projected amounts (Table 5).

The effect of this alternative on the marginal corporate rate would be somewhat more than half again as large as that under H.R. 13511. The nature of the effects would be the same as those described above, but the feedback effects would be somewhat larger.

TABLE 1.—ECONOMIC AND TAX REVENUE EFFECTS OF H.R. 13511

[Dollar amounts in constant 1977 dollars]

	1979	1981	1983	1988
Increase or decrease (—) in—				
Employment (thousands of full-time equivalent employees)	1,250	1,400	1,510	1,830
Annual wage rate	$540	$650	$750	$1,030
Gross national product (billions):				
Total	101	129	156	222
Business sector	83	102	119	166
Gross private domestic investment (billions):				
Total	51	95	137	104
Nonresidential	47	91	128	91
Consumption (billions)	49	34	19	118
Federal tax revenues (billions): Net of feedback	6	3	(3)	2

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

TABLE 2.—ECONOMIC AND TAX REVENUE EFFECTS OF H.R. 13511: WIDEN INDIVIDUAL INCOME TAX BRACKETS REDUCE TAX RATES, INCREASE ZERO RATE BRACKET, INCREASE PRESENT EXEMPTION, AND ELIMINATE THE GENERAL TAX CREDIT

[Dollar amounts in constant 1977 dollars]

	1979	1981	1983	1988
Increase or decrease (—) in—				
Employment (thousands of full-time equivalent employees)	830	910	960	1,110
Annual wage rate	$150	$180	$190	$250
Gross national product (billions):				
Total	39	48	55	72
Business sector	34	41	46	60
Gross private domestic investment (billions):				
Total	15	27	38	26
Nonresidential	13	24	33	19
Consumption (billions)	24	21	17	46
Federal tax revenues (billions): Net of feedback	(4)	(5)	(8)	(8)

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

TABLE 3.—ECONOMIC AND TAX REVENUE EFFECTS OF THE ARCHER AMENDMENT IN H.R. 13511 INDEX CAPITAL GAINS

[Dollar amounts in constant 1977 dollars]

	1979	1981	1983	1988
Increase or decrease (—) in—				
Employment (thousands of full-time equivalent employees)	310	350	400	560
Annual wage rate	$270	$330	$390	$590
Gross national product (billions):				
Total	43	56	70	111
Business sector	34	42	51	79
Gross private domestic investment (billions):				
Total	24	45	69	59
Nonresidential	21	42	63	50
Consumption (billions)	19	11	2	52
Federal Tax Revenues (billions): Net of feedback	10	10	9	15

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

TABLE 4.—ECONOMIC AND TAX REVENUE EFFECTS OF H.R. 13511: REVISE CORPORATE INCOME TAX RATE STRUCTURE

[Dollar amounts in constant 1977 dollars]

	1979	1981	1983	1988
Increase or decrease (—) in—				
Employment (thousands of full-time equivalent employees)	100	110	120	130
Annual wage rate	$90	$100	$110	$140
Gross national product (billions):				
Total	14	18	21	27
Business sector	11	13	15	19
Gross private domestic investment (billions):				
Total	7	14	18	10
Nonresidential	8	12	20	11
Consumption (billions)	7	4	3	17
Federal tax revenues (billions): Net of feedback	(1)	(1)	(1)	0

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

TABLE 5.—REDUCE CORPORATE NORMAL TAX RATE TO 17 PERCENT, INCREASE SURTAX RATE TO 28 PERCENT AND INCREASE SURTAX EXEMPTION TO $100,000

[Dollar amounts in constant 1977 dollars]

	1979	1981	1983	1988
Increase or decrease (—) in—				
Employment (thousands of full-time equivalent employees)	160	180	190	210
Annual wage rate	$140	$160	$180	$220
Gross national product (billions):				
Total	22	28	32	42
Business sector	18	21	23	29
Gross private domestic investment (billions):				
Total	12	20	29	19
Nonresidential	9	19	27	16
Consumption (billions)	11	8	3	23
Federal tax revenues (billions): Net of feedback	1	0	1	1

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

33-017—78——3

APPENDIX C

DISTRIBUTION OF CORPORATIONS BY TAXABLE INCOME GROUPS

[Excludes form 1120S and form 1120 DISC returns]

Taxable income[1]	1969 Number of taxable returns	1969 Percent of total	1974 Number of taxable returns	1974 Percent of total	1974 Percent change from 1969	1979 Number of taxable returns	1979 Percent of total	1979 Percent change from 1969
$1 to $24,999	593,605	76.3	640,508	73.5	7.9	674,520	67.2	13.7
$25,000 to $49,999	92,081	11.8	102,801	11.8	11.6	133,286	13.3	44.7
$50,000 to $99,999	44,153	5.7	56,295	6.4	27.5	74,766	7.5	69.3
$100,000 to $149,999	15,686	2.0	20,728	2.4	32.1	31,141	3.1	98.5
$150,000 and over	32,760	4.2	50,393	5.9	53.8	89,051	8.1	171.8
Total	778,288	100.0	870,725	100.0		1,002,764	100.0	
Zero income[2]	646,726		755,609		16.8	919,497		42.0

[1] Returns with income taxed at normal tax and surtax rates.
[2] Includes returns with zero income and net losses.

Sources: 1969 data from "Statistics of Income—1969 Corporate Income Tax Returns," IRS; 1974 and 1979 data from the Office of Tax Analysis, Department of the Treasury, March 1978.

APPENDIX D: COMPARATIVE TAX LIABILITIES

Corporate taxable income	Alternative tax structures[1] Present law	H.R. 13511	Surtax exemption
$25,000	$5,000	$4,250	$4,250
$50,000	10,500	9,250	8,500
$75,000	22,500	16,750	12,750
$100,000	34,500	26,750	24,250
$200,000	82,500	72,750	70,250

[1] Alternatives: Present law—20 percent on 1st $25,000; 22 percent on $25,000 to $50,000; 48 percent on $50,000 plus; H.R. 13511—17 percent on the 1st $25,000; 20 percent on $25,000 to $50,000; 30 percent on $50,000 to $75,000; 40 percent on $75,000 to $100,000; 46 percent on $100,000 plus; surtax exemption—17 percent on the 1st $75,000; 46 percent on $75,000 plus. (This was offered as an alternative to the proposal which was included in H.R. 13511.)

STATEMENT OF WALLACE J. CLARFIELD ON BEHALF OF THE TAX COUNCIL

SUMMARY

H.R. 13511

1. A good tax bill.

2. Individual income tax cuts with tilt towards middle brackets mark important departure from practice of concentrating cuts where there is little if any benefit re capital formation.

Hope tilt will prove first step towards correcting steep progressivity of rates through middle brackets.

3. Repeal of deduction for state-local gasoline taxes should not become precedent for eliminating deduction of other taxes.

4. Instead of a high limitation on the exclusion of Unemployment Compensation Benefits, the exclusion should be ended entirely.

5. Should not repeal deduction for political contributions.

6. Deferred compensation provisions are timely and constructive.

7. Business tax cuts are needed and welcome.

Deeper cuts are needed in the top rate of corporate tax.

Suggest combining first two steps of the four-step increase to 90 percent of the 50 percent limitation on the use of the investment credit.

Full investment credit for pollution control facilities eligible for 5-year amortization will be helpful.

8. Provisions with respect to taxing capital gains are most encouraging.

Deletion from list of tax preferences coincides with Council policy.

Alternative minimum tax on capital gains consistent with Council views.

URGE that action to repeal the alternative capital gains tax not be taken independently of a reduction of all rates of capital gains tax to a new top rate not higher than 25 percent. Council proposes increasing exclusion from 50 to 65 percent which would cut all rates by 30 percent and bring top rate down to 24.5 percent.

Happy to support onetime $100,000 exclusion on sale of homes although Council policy calls for end of this taxation which would permit ending the complex rollover provision.

Praiseworthy omissions from H.R. 13511

1. H.R. 13511 is a good bill because of what's not in it as well as what is.
2. In the foreign area alone, phasing out of DISC and so-called "Deferral" as proposed by the Administration would have significant adverse impact on our domestic economy.

My name is Wallace J. Clarfield. I am Vice President—Taxes of Olin Corporation of Stamford, Connecticut. I appear here in behalf of The Tax Council of which I am a Director and Chairman of the Tax Policy Committee.

The Council is a nonprofit, business supported organization solely concerned with federal tax policy. From its inception twelve years ago the Council has stressed the benefits to the public which would flow from a tax structure less biased against capital.

H.R. 13511 is a good tax bill and we appreciate the opportunity to appear in these hearings in support of it.

This statement briefs our views with respect to the provisions of the bill in which the Council is especially interested and with respect to the Administration's proposals re DISC and "Deferral" of tax on foreign source income.

1. *Individual income tax reductions.*—The balance in reductions between income levels with a slight tilt towards the middle levels marks an important departure from the practice of concentrating reductions where there is little if any benefit re capital formation. To a large extent, the potential for increased savings as incomes move into the middle and higher brackets is canceled out by the steep rise of the income tax rates. Although often overlooked in the dialogue on taxes and economic growth, the progressive rates are a contributing factor in the lag in capital spending and productivity which so seriously mar our contemporary economic performance. To flatten out the curve of progressivity through the middle brackets, as proposed in Council policies, would require cuts running up to 50 perecnt in some brackets while all rates are being cut an average of about 30 percent, as shown on the attached chart. With the large and repetitive tax cuts, pre-scheduled or annually enacted, to be expected over the years immediately ahead, correcting the counterproductiveness of the middle of higher bracket rates will be quite feasible from the fiscal standpoint. We hope the tilt in H.R. 13511 will prove the first step towards such corrective action.

2. *Other individual tax provision of H.R. 13511.*—

(a) Repeal of deduction for state-local nonbusiness gasoline taxes: While it may be unrealistic under present circumstances to oppose repeal of the provisions pemitting deduction of these taxes, the result would be a new area of double taxation. If the Committee on Finance concurs in the repeal, we hope your Report on the legislation will make clear that the action should not be considered as a precedent for eliminating the deductions now permitted for any other taxes.

(b) Limitation on exclusion of unemployment compensation: The exclusion of unemployment compensation benefits should be ended entirely. In this day and age of two-worker families, the exclusion served as an enticement to move in-and-out of the labor force causing more inflation by adding to employer costs and further diminishing the low level of productivity. Workers who lose their jobs through no fault of their own and who come to need financial help should receive it through other means and not through a tax exclusion which makes periods of idleness attractive in so many cases.

(c) Political contributions: The House Committee report gives no reason of substance for eliminating the deduction while retaining the credit for political contributions. A deduction correlates relief with progression whereas a flat rate or ceiling credit compounds the progression beyond the point of relief. The principle is important even though the amounts here involved are small. We hope the deduction is retained.

(d) Deferred compensation: The provisions of H.R. 13511 regarding deferred compensation are timely and constructive and we hope they will be included in the legislation as enacted.

3. *Business tax reductions*.—The tax cuts in the business area are needed and welcome and inevitably will result in more capital spending and a better productivity record than otherwise would exist. With respect to the top corporate rate, however, much more is needed to be done. The Council believes this rate should be reduced to a level below 40 percent.

With respect to the increase in the 50-percent limitation on use of the investment credit of 10 percentage points a year to a new limitation of 90 percent, we suggest the Committee consider combining the first two steps in the first year of effectuation, to be followed by 10 percentage point increases in the following two years. This would be especially helpful to the many enterprises with strong growth potential which have difficulty in generating adequate capital funds from external sources.

The allowance of the full investment credit for pollution control facilities which are eligible for 5-year amortization will correspondingly diminish the extent to which capital spending for pollution control is at the expense of spending on productive facilities. The argument over who should bear the burden of spending for pollution control overlooks the point that the public as a whole is deprived of the benefits which would flow from using the capital involved to add to productive facilities. The public interest would be served if, in addition to the full credit, business taxpayers could write off pollution control expenditures as rapidly as desired.

4. *Capital gains*.—Overall, the provisions of H.R. 13511 with respect to taxing capital gains are most encouraging. If enacted without revision, they would constitute a much needed, strategic step away from the baffling tax reform concept that capital gains are just another form of income. Our views on the conceptual and economic aspects of taxing gains were set forth in some depth in a statement "A Wasteful and Repressive Tax", dated June 28th, submitted to your Subcommittee on Taxation and Debt Management by Council President John C. Davidson.

Of the specifics of capital gains changes included in the bill, the provision for deletion from the list of tax preferences under the minimum and maximum taxes coincides precisely with Council policy. Our understanding of legislative history is that the pre-1969 taxing of gains was not intended to grant a preference as regards income taxation but reflected Congressional judgment as to the level of taxation appropriate to the tax object. The alternative minimum tax on capital gains provided in the bill is consistent with our view that capital gains are something apart from income.

With respect to repeal of the alternative capital gains tax, we urge that such action not be taken independently of a reduction of all rates of tax on capital gains with a new top rate not higher than 25 percent. The Council proposal is that the exclusion be increased from 50 to 65 percent. This would reduce all rates by 30 percent and bring the top rate down to 24.5 percent (if the top rate of income tax remains at 70 percent as provided in H.R. 13511). Needless to say, we would be delighted if this Committee and the Congress should decide at this time to make an even deeper cut in the taxes on gains. Because any taxing of gains constitutes a withdrawal from the nation's stock of capital which must be replenished by new savings out of current income before there is net addition to the stock, the economics of growth would be served by taking gains entirely off the tax list.

Council policy has long called for an end to the taxing of gains on the sale of homes, so we are happy to support the one-time exclusion of $100,000 provided in H.R. 13511. We question, however, whether the revenue involved from sales remaining subject to rollover justifies retention of this complex provision in the Code instead of ending the tax. While it is mostly a theoretic point in this era of ever-higher prices on homes, the Council policy is based on the principle that there should be no tax on a gain from the sale of a property unless there would be an offset against tax if a loss were to be realized.

5. *Praiseworthy omissions*.—H.R. 13511 is a good bill because of what's not in it as well as what is. In the foreign area alone, the Administration's proposals if enacted would have significant adverse impact on our domestic economy. Specifically—

By its own figures, the phasing out of DISC which it proposes would in the first year take a billion dollars out of funds available for capital spending.

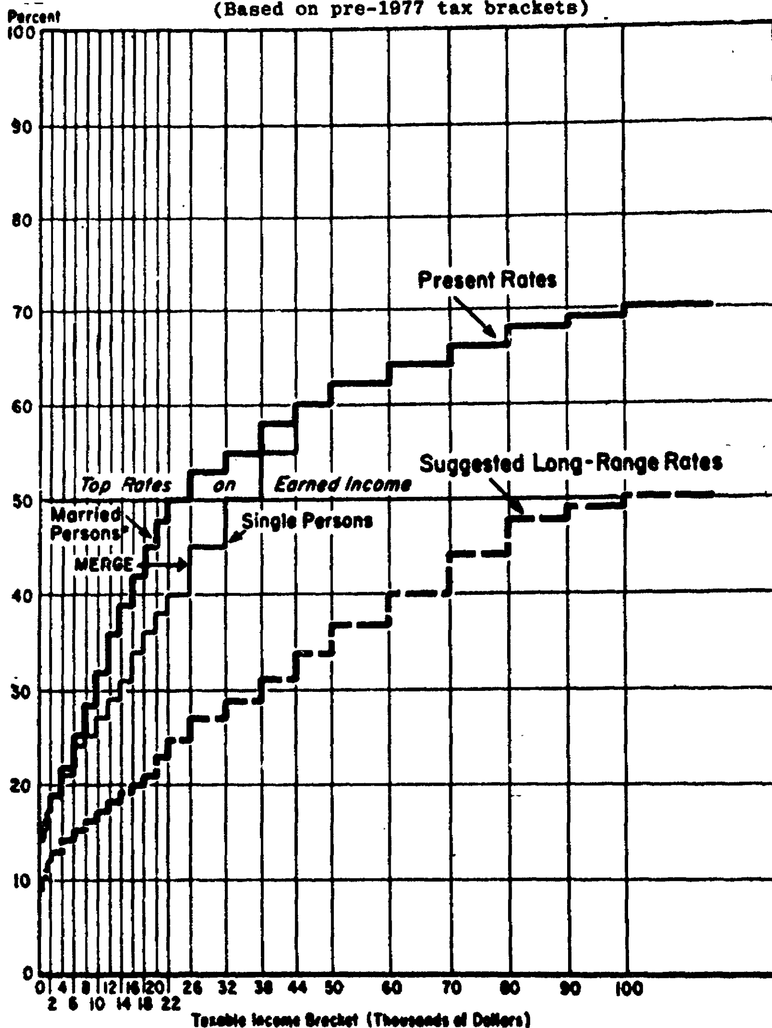
Its proposal to phase out what is known as deferral of tax on foreign subsidiary earnings would be more aptly described as a proposal to exact tax on income before it is remitted to the U.S. Because of adjustments in reinvestment of foreign earnings, product mix and situs of foreign operations which would take place

if the affected earnings should be subject to tax before remittance to the U.S., there is serious question whether there would result any continuing revenue gain to the U.S. government. However, there is no question that any increase in U.S. tax revenue from foreign business earnings would—

(a) Adversely affect the balance of payments over the years ahead by diminishing the return flow of income from direct foreign business investment

(b) In the short-and-longterm, diminish the amount of capital available for domestic purposes.

(c) Reduce job opportunities in the United States (i) by reduced demand for exports of goods and services to back up U.S. foreign investment and operations, (ii) for personnel in support of foreign investments and operations, and (iii) by the reduction in available capital.



Supplemental Statement of Wallace J. Clarfield

The Secretary asks for a redistribution of the personal tax cuts in the customary egalitarian mold of professional tax reform. He says the share of the tax cut going to persons below $20,000 of income should be increased from about 25 percent to about 40 percent while the share going to those above $50,000 should be decreased from 24 percent to about 10 to 15 percent. These figures indicate a proposed shift from the $20,000–$50,000 group to the below $20,000 group of one to six percent. Yet, the Secretary's statement says they suggest "increased tax savings in the bill for all income categories through a level of about $50,000." More specifically, he says the Committee on Finance is urged to substitute for the $1,000 exemption and rate cuts included in the House bill "a $240 personal credit and a new rate schedule that direct greater relief to middle and low-income families". He does not say that the economy would benefit by these moves but instead employs the politically-primed arguments that fairness and equity and the principal of ability to pay would thus be served. He further says the $1,000 exemption would mean a $700 tax savings in the highest bracket but only a $140 saving in the lowest bracket, not mentioning the reason that a 70 percent rate applies in the top bracket but a 14 percent rate applies in the first.

Overall, the text presented by the Secretary in this area intentionally or not seems to mask the shift in tax burdens which would result from substituting a $240 credit for a $1,000 exemption. While to our knowledge the Treasury has not in a public statement put a dollar tag on the shift, this spring we were advised by telephone that the tag was a four billion dollar transfer of tax burdens out of the lower incomes (roughly under $20,000) into higher brackets mostly in the range of $20,000 to $50,000.

There is nothing inherently fair nor equitable about a tax system which is biased against the saving and investing which serves all the people. It hardly seems arguable but that rates above 50 percent, as well as steeply progressive rates up to 50 percent, are so biased. I consider those above 50 percent confiscatory while it is evident that anything more than a moderate climb of progressive rates penalizes and punishes the doers and achievers of a society.

Ability-to-pay is a humanitarian concept which expresses the universal concern for avoiding excessive tax imposts on people with small incomes. Beyond this, however, it does not provide any kind of a sensible or even a non-sensible guide to an acceptable degree of progressivity. Specifically, there is nothing in the principle which requires:

"Punishing or penalizing rates of tax at any income level.

"That every tax bill be tilted away from relief from such rates and toward the lowest rates.

"That the public interest in increased savings, more capital spending and increased productivity always be subordinated to more tax relief in the lowest rates."

When the Administration last year failed to develop a substantive case or a coherent principle to justify its intended recommendation that capital gains be taxed at income tax rates, it finally resorted to the ability-to-pay principle. This precipitated the observation that the principle is the last refuge of a tax reformer without a case. At that time, Council President John C. Davidson prepared a brief writing entitled "The Principle of Ability-to-Pay and The Taxing of Capital Gains", which is available for inclusion in the record of these hearings.

As I noted in my full statement (with respect to political contributions), a deduction correlates relief with progression whereas a flat rate or ceiling credit compounds the progression beyond the point of relief. The proposal for a $240 credit simply is not compatible with the contemporary awareness and concern about the tax burdens through the middle brackets.

Statement for the Chamber of Commerce of the United States

(By Jack Carlson)

I am Jack Carlson, Vice President and Chief Economist of the Chamber of Commerce of the United States. I am accompanied by Christine L. Vaughn, the Acting Director of the Chamber's Tax Policy Center and Kenneth D. Simonson, the Chamber's Tax Economist. On behalf of the National Chamber's 76,000 members, we greatly appreciate the opportunity to present our views on the current need for tax relief.

Summary

The National Chamber recommends that the Senate adopt a program of substantial tax relief, accompanied by realistic but firm limitations on the growth of federal spending. We recommend:

$25 to $30 billion of tax relief on an annual basis, about twice as much as passed by the House;

Targeting one-third or $8 to $10 billion of the tax relief to encourage job-creating, capacity-expanding and inflation-dampening investment;

$32 billion or 7 percent limit to the growth of Budget Outlays, enough to provide for current services and prior commitments;

Limiting the growth of Budget Authority which is excessively building up spending for fiscal years 1980 and 1981; and

Limiting the federal deficit to $35 to $40 billion, required to help bring down inflation and allow interest rates to subside.

Specifically, we believe that this Committee should:

Reduce the top corporate tax rates, by at least 4 percentage points;

Reduce the corporate tax rates on small business to a greater extent than is contained in H.R. 13511;

Liberalize the investment tax credit, including extending it to all productive structures and without limitation based on tax liability;

Reduce the tax on capital gains by at least $2 billion;

Move toward a complete capital cost recovery system; and

Begin to eliminate the double taxation of corporate income.

The National Chamber also urges an across-the-board reduction in the individual tax rates of $17 to $20 billion.

The Chamber's program serves three important current economic priorities: encouraging economic growth and job creation through greater capital formation; reducing inflation through increased productivity of workers and expanded capacity; and slowing the growth of government in order to restore more individual discretion over resources and decision making.

The bill passed by the House is a small step in the right direction. But much stronger tax relief is needed in a year when the economy is struggling with uncertain continued growth, persistently high inflation and stubborn unemployment. In particular, more relief should be targeted toward business, especially small business, the backbone of our employment and output.

THE PLIGHT OF SMALL BUSINESS

The Chamber is particularly concerned about the heavy burden of taxation facing small businesses. Since 1964, only one tax measure has given significant relief to small businesses: the creation of a 22 percent bracket for the second $25,000 of taxable income, and the reduction in the tax rate from 22 to 20 percent on the first $25,000. Yet prices have doubled in those 14 years, leaving many small businesses with lower real after-tax income. It is time for Congress to redress this loss by raising the current surtax exemption and lowering corporate rates, rather than adopting the anemic, complicated, and piecemeal graduated rates and multiple brackets approved by the House. Instead, we advocate a $200,000 surtax exemption, with a 15 percent rate applied to the first $50,000 of taxable income, and a 22 percent rate on the next $150,000. This approach gives more needed tax relief to small businesses than does the House bill.

THE ECONOMIC SITUATION

The economy is in fragile condition. The unemployment rate in July returned to the 6.2 percent level that it has hovered near since the beginning of the year. All forecasts point to a slowdown in economic growth during the next several quarters, perhaps even to a recession, with increasing unemployment in any case. Meanwhile, productivity gains continue to be small. The Bureau of Labor Statistics' index of output per hour of all persons in the private business sector was virtually unchanged last quarter from the beginning of 1977.

At the same time, inflation and interest rates are at historically high levels and are threatening to go higher. Unit labor costs in the private business sector have increased by 8.8 percent since one year ago. Both producer and consumer prices have risen at double-digit rates so far during 1978. Short and long-term interest rates climbed steadily until recently, and will be under continuing pressure for the remainder of the year from the large federal deficit financing requirements and rapid money supply growth which has frequently exceeded already high targets.

A longer view also gives cause for concern. The last recession ended in the first quarter of 1975, yet the unemployment rate has fallen below 6 percent in only one month since 1974. In all but one of the last ten years from 1969 through mid-1978, inflation (as measured by the implicit price deflator for GNP) has been at a 5 percent rate or worse. Over that same period, corporate profits after

taxes (with inventory valuation and capital consumption adjustments), the chief source of investable funds for job creation and income growth, have risen by only 50 percent, less than the increase in inflation, while federal outlays and taxes have gone up by about 120 percent, much more than inflation. It is high time to adjust these growth rates by leaving more money in the hands of those who earned it, where it can be used for job creation and capacity expansion, and by imposing feasible limitations on the growth of federal expenditures.

THE CASE FOR INCREASED TAX RELIEF

The Chamber advocates a tax cut of $25 to $30 billion, compared with the $16.3 billion contained in H.R.13511.

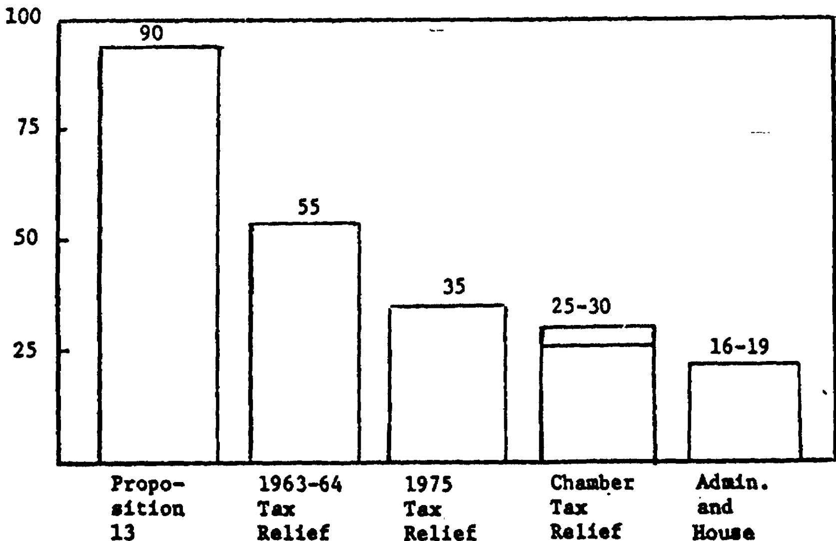
Given the high rate of inflation and large federal deficit now burdening the economy, it may sound surprising that the National Chamber is advocating a larger tax cut than the one the House passed. In fact, there is every reason to support an enlarged cut, coupled with slower growth of federal outlays.

We are pleased to note that Congress has begun to recognize the need to lower federal spending growth. Last month, the Chairman of the House Budget Committee recommended fiscal 1979 outlays of $490 billion, a significant reduction from the $499 billion adopted by Congress in the First Budget Resolution in May. And we are encouraged by the large number of Representatives who supported the amendments offered by Representatives Holt, Latta, and Fisher last week in the House as it attempted to trim FY 1979 outlays still more. And who can fail to be impressed by the overwhelming desire voters have shown nationwide to limit government taxes and spending since the triumph of Proposition 13 in California.

In short, the time is ripe for Congress to limit FY 1979 outlays to $480 billion, a level which would provide enough for current services and prior commitments while making possible a larger tax cut without raising the deficit. A $480 billion budget would still permit a 7 percent growth in expenditures and the deficit would decline significantly. Moreover, it should be kept in mind that one-third of the Chamber's recommended $25–$30 billion of tax relief would be directed toward job-creating, production-raising investment, which would shortly begin to offset the initial revenue loss to the Treasury.

Finally, the size of relief we are advocating is moderate compared with other recent tax relief measures, especially in view of the fragile state of the economy (see Chart 1).

CHART 1.—CHAMBER TAX RELIEF COMPARED WITH OTHER TAX RELIEF [1]



[1] Tax relief in other years or for a state were sized for the U.S. economy in fiscal year 1970 in annualized billions of dollars.

THE NEED TO STIMULATE INVESTMENT

Not only the size of the tax relief but also its composition are important for fighting inflation, increasing wages and providing jobs. The federal tax structure greatly discourages investment in modern tools for the growing work force. For example, the allowance provided under tax laws for replacing worn out equipment and structures was $17 billion short of replacement costs during 1977. Consequently, taxes were artificially increased and the Federal government siphoned funds away from investment.

Investment, after adjusting for inflation, has grown only 1.1 percent annually since 1973 while the number of new workers needing modern tools has grown by 2½ percent annually. In spite of slightly fewer working hours, capital per labor hour is growing more slowly and is a major cause for slower productivity growth and a decline in real average weekly earnings of non-farm workers (see Table 1).

TABLE 1.—SLOWING ANNUAL GROWTH RATES IN INVESTMENT AND THE RESULTING SLOWDOWN IN PRODUCTIVITY AND REAL WAGES GROWTH [1]

[In percent]

	Investment growth after Adjusting for inflation	Capital per labor hour	Productivity growth	Real[2] wages
1948–66	3.4	3.1	3.3	2.7
1966–73	3.0	2.8	2.1	1.0
1973–78 (2d quarter)	1.1	1.5	0.8	–1.0

[1] Economic Report of the President, January 1978, and Bureau of Labor Statistics.
[2] Real average weekly earnings in nonagricultural industries.

Government tax and spending policies have increasingly ignored the plight of workers having to work with obsolete and worn out tools. A greater proportion of tax relief provided in the past was earmarked for encouraging investment in plant and equipment. The 1963–64 relief, which is widely credited with contributing to our longest period of uninterrupted growth, channeled one-third of its relief to investment. The House bill grants only a quarter of its relief to investment.

Even seemingly useful legislation enacted for other reasons during 1977 will reduce investment by $2,900 for each new worker during 1979 (see table 2).

TABLE 2

Legislation enacted by the Congress and signed into law by the President during 1977	Impact on investment for each new worker			
	1978	1979	1980	1985
Increase in minimum wage	$150	$2,350	$2,600	$2,400
Increase in social security taxes	0	–200	–600	–2,750
Increase in farm price supports	–150	–250	–200	–250
Increase in Federal pay	–50	–100	–100	–100
Total	350	2,900	3,500	5,500

This trend toward discouraging investment in modern tools for American workers must be reversed. Thus the National Chamber recommends that one-third of tax relief be earmarked for encouraging investment.

The Chamber-Gallup Business Confidence Survey indicates that one-half of American businesses would increase their investment in equipment and structures if tax relief were provided to stimulate investment. Moreover, the investment would occur in all regions of the country, including central cities which contain distressed economic areas.

Based upon forecast economic conditions and experience, each initial $1 billion of tax relief could cause as high as $6 billion to be spent for plant and equipment,

cause production capacity to expand by as much as 0.3 percent which would reduce bottleneck inflation, create 240,000 new jobs, and increase average family income by as much as $80 (see Table 3).

TABLE 3.—IMPACT OF $1,000,000,000 OF TAX RELIEF WITHIN 4 YEARS

	Investment tax credit	Capital gains	Depreciation allowance	Corporate rate
Investment (billions)	$4–$6	$2–$4	$2–$3	$1–$1
Capacity expansion (percent)	0.3	0.2	0.2	0.1
Jobs (thousands)	180–240	100–180	110–170	60–90
Family income	$60–$80	$35–$60	$35–$50	$20–$30

We are encouraged that the Administration agrees that substantial tax relief for business is required. As Treasury Secretary Blumenthal told this Committee last Thursday, "Incentives, in the form of business tax cuts, are needed to improve this disappointing record of business fixed investment and to avoid inflationary capacity bottlenecks in the years ahead." In light of this recognition, it is unfortunate that the Administration seeks only $4 billion or so of business tax relief. As we noted earlier, the Chamber believes $8–$10 billion would be more appropriate.

Tax relief to stimulate investment results in two-thirds of the final benefits accruing to low or middle income families. About two-thirds of the investment-led growth in the economy occurs in wages and salaries which are paid primarily to workers from low and middle income families.

Creating jobs through investment could be far less costly than public sector jobs or public works (see Table 4).

TABLE 4.—*Increased employment from investment—Stimulating tax relief compared to other stimulus for creating new jobs, fiscal year 1979*

	Tax relief or spending cost per job
Higher investment tax credit, capital gains tax reduction, or improved depreciation allowance.	$5,000 to $10,000.
Public sector jobs spending	$10,000 to $13,000.
Labor intensive public works spending	$25,000 to $35,000.
Proposed local public works spending	$25,000 to $50,000.

ECONOMIC CONSEQUENCES

Without the combination of investment-stimulating tax relief and budgetary restraint advocated by the Chamber, we fear that the Federal government's fiscal policies could produce:

Persistent inflation at or above 7 percent;

Unemployment at or above 6 percent;

Low rates of investment; and

Greater loss of individual freedom because of taxes and spending growing faster than income.

In contrast to the House bill and the Administration's Economic Outlook, the Chamber's recommendations would create 300,000 additional jobs and produce the following improvements for the average American family:

Save $230 in federal taxes in 1979;

Retain individual choice and freedom by reducing government spending and taxes; and

Reduce consumer prices by ¼ to ½ percent, equivalent to $100 of purchasing power.

TABLE 5.—ECONOMIC IMPACT OF CHAMBER TAX RELIEF AND SPENDING LIMITATION RECOMMENDATIONS COMPARED TO ADMINISTRATION OUTLOOK[1]

[Change in levels]

	Fiscal year 1979	Fiscal year 1980
Gross national product (percent)	0.2	1.0
Consumption	.3	1.0
Business fixed investment	.5	3.2
Net exports	11.0	12.0
Employment (million jobs)	.2	.3
Unemployment rate (percent level)	-.1	-.2
Aftertax family income	$146	$315
GNP deflator	-.3	-.3
Consumer prices	-.3	-.4
Capacity utilization (percent level)	1.0	2.0
AAA corporate bonds (level change)	-.1	-.1

[1] Fiscal policy assumptions: Personal tax relief of $15,000,000,000 in fiscal year 1979 (equivalent to $20,000,000,000 in calendar year 1979). Investment tax relief of $7,000,000,000 in fiscal year 1979 (equivalent to $10,000,000,000 in calendar year 1979). Federal spending limitation of $32,000,000,000 increase (current services budget) in fiscal year 1979.

Source: U.S. Chamber of Commerce, Forecast and Survey Center. Assumptions and modeling by Dr. Jack Carlson and George Tresnak using econometric models of Data Resources, Inc., and Chase Econometrics Associates.

The chamber's recommendations would provide tax relief for families in every state (see table 6). For example, the average family in Louisiana would save roughly $209 on its 1979 taxes from a $2 billion personal income tax cut.

TABLE 6.—*Tax relief for an average family for 1979 from Chamber's recommendations*

State	Tax relief	State	Tax relief
United States	$230	Missouri	$215
Alabama	215	Montana	211
Alaska	371	Nebraska	240
Arizona	220	Nevada	245
Arkansas	213	New Hampshire	221
California	271	New Jersey	293
Colorado	265	New Mexico	184
Connecticut	296	New York	271
Delaware	293	North Carolina	206
District of Columbia	309	North Dakota	265
Florida	221	Ohio	215
Georgia	220	Oklahoma	202
Hawaii	295	Oregon	220
Idaho	215	Pennsylvania	227
Illinois	296	Rhode Island	230
Indiana	221	South Carolina	196
Iowa	227	South Dakota	202
Kansas	232	Tennessee	199
Kentucky	202	Texas	224
Louisiana	209	Utah	293
Maine	201	Vermont	207
Maryland	290	Virginia	236
Massachusetts	215	Washington	239
Michigan	234	West Virginia	196
Minnesota	234	Wisconsin	229
Mississippi	171	Wyoming	230

INVESTMENT TAX RELIEF

Significant tax reduction must focus upon the need to promte capital formation. The Chamber's recommendations for specific changes needed in the tax laws to direct tax reduction measures toward stimulating job-creating, capacity-exuanding, and inflation-dampening investment are discussed in detail below.

CORPORATE TAX RATE REDUCTION

Congress should adopt an across-the-board tax reduction for individuals and corporations. As part of an overall cut in taxes, tax rates should be reduced to permit and encourage the reinvestment of earnings in sufficient amounts to promote economic progress and provide jobs.

The present corporate income tax deters business expansion, diminishes sources of equity funds and discourages new investment, by reducing incentives. A reduction in the corporate tax rate would help provide the new capital necessary to permit and encourage investment of earnings in sufficient amounts to promote healthy economic progress.

Under the House bill, the corporate rate on taxable income in excess of $100,000 would be reduced by two percentage points to 46 percent, effective December 31, 1978. The present normal tax and surtax structure would be replaced by a complex five-step rate structure, with a 17 percent tax on the first $25,000 of taxable income (down from 20 percent under present law); 20 percent on the next $25,000 (down from 22 percent); 30 percent on the next $25,000; and 40 percent on taxable income from $75,000 to $100,000.

The Chamber supports corporate tax rate reduction but favors more significant reduction. The top corporate rate should be lowered at least to 44 percent. The Chamber proposes greater tax relief for small business. The surtax exemption should be increased to $200,000, with 15 percent normal tax on the first $50,000 subject to the exemption (down from 20 to 22 percent under present law), and 22 percent on the next $150,000.

INVESTMENT TAX CREDIT

One effective method for channeling funds into productive investments is the investment tax credit. Several studies have testified to its efficacy, and it has won wide aceptance. The present investment tax credit is 10 percent of qualified investment, but the tax code provides that the credit will revert to 7 percent for most industries as of January 1, 1981. The House bill would make permanent the temporary investment credit rate of 10 percent for all taxpayers, effective January 1, 1981, when the temporary extensions are scheduled to expire. Because the economy cannot afford an on-again, off-again approach to the investment credit absent a modern capital cost recovery system, the Chamber favors making the credit permanent, but at a rate of 12 percent.

Presen law limits the availability of the investment credit for taxpayers in most industries to $25,000 plus 50 percent of tax liability in excess of $25,000. The House bill would increase the present 50 percent tax liability limitation to 90 percent, but would do so by phasing in the increase by an additional 10 percentage points per year beginning with taxable years which end in 1979. The Chamber urges that the credit be computed without limitations based on tax liability. At the very least, this Committee should consider shortening the time period over which an increase in the present percentage limitation becomes effective.

The Chamber supports extending the investment tax credit, as the Administration had proposed in January, to new structures as well as rehabilitation expenditures for existing structures. However, the term "structures" should be broadly defined, and should include manufacturing, utility, retail, and commercial structures. Under present law, buildings and their structural components are not eligible for the credit. The House bill would extend the credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except those used for residential purposes. Rehabilitation would include the renovation, restoraton, and reconstruction of an existing building which has been in use for a period of at least 5 years before the commencement of the rehabilitation. If Congress determines that it is appropriate to enable business to rehabilitate and modernize existing structures in order to promote greater economic stability, primarily in older neighborhoods, then we question whether use of the credit should be restricted by excluding costs incurred for enlargement of existing buildings.

Property becomes eligible for the credit under present law when it is placed in service, or in certain cases when it is completed. As a result of the 1975 Act, a taxpayer may make an irrevocable election to have the investment tax credit apply to qualified progress expenditures for long leadtime property. This progress payments provision should go even further by making the credit available

for all investments in qualified property in the years that the expenditure is made, rather than in the years that the property is placed in service or completed.

Finally, the Chamber favors increasing the limitation on the investment tax credit for qualified used equipment to $200,000. The House bill would make permanent the present $100,000 annual limitation, which is scheduled to return to $50,000 in 1981. Many businesses can afford to modernize their plants only with used equipment, but inflation has driven up the cost of even used items beyond the present $100,000 limit. Increasing the limitation on the investment tax credit for used equipment would also facilitate the purchase of new equipment by others, due to an increase in the demand for used equipment.

Present law allows taxpayers who use the special five-year amortization period for pollution control facilities to claim only one-half the present investment credit. H.R. 13511 generally would allow the full 10 percent credit for pollution control equipment, a move the Chamber supports. As the House Repodt explains:

> In many cases, installation of the equipment in an existing facility neither increases production efficiency nor incerases the capacity to produce. The costs of pollution control then must be included in product prices, which has inflationary implications and also tends to reduce the rate of return on investment.

However, under the House bill, pollution control equipment financed by industrial development bonds would not be eligible for the increased credit. Treasury Secretary Blumenthal testified last week that the Administration favors a full credit for pollution control facilities only if the tax exemption for industrial development bonds used to finance them is repealed. The National Chamber supports a full investment credit for pollution control facilities along with all other equipment and structures, and without the restrictions proposed by the House or the Administration.

CAPITAL GAINS TAXATION

The Chamber urges this Committee to adopt capital gains tax relief of at least $2 billion, equivalent in size to S. 3065, the so-called Hansen-Steiger bill. Our economy faces a major need for capital which we cannot afford to ignore. Special tax treatment for capital gains is one way that the capital formation so essential to our economic well-being can be encouraged.

As we testified before this Committee's Subcommittee on Taxation and Debt Management on June 28, 1978, the Chamber supports achieving capital gains tax relief through a reduction in the rate of tax, expansion of the capital gains deduction, and/or adoption of a capital gains "rollover" to permit nonrecognition of gain from the sale of certain small business investments. The Chamber favors modification of the rate of taxation of capital gains by providing for reduced taxation of capital gains proportionate to the length of time a capital asset is held, with the reduction being gradual and continuous.

Two billion dollars of capital gains tax relief would, within four years:

Increase wages by at least $8 billion, primarily for lower and middle income workers;

Add at least 200,000 jobs;

Increase business fixed investment by at least $4 billion;

Reduce long-term interest rates by at least 0.4 percentage points;

Increase after tax income for the average family by at least $70;

Generate additional tax receipts and offset a significant portion of the initial tax relief;

Help small business people;

Help farmers, timber, energy and mineral producers;

Help older people selling their homes and other assets to convert them into income producing assets; and

Increase individual freedom.

The House bill provides significant relief from capital gains taxation. It eliminates capital gains as an item of tax preference subject to the existing 15 percent minimum tax for both individual and corporate taxpayers; provides for indexing the cost basis of three types of assets (common stock, tangible personal property, and real property) to adjust for inflation, beginning in 1980; and allows an individual to elect a once-in-a-lifetime exclusion from income of up to $100,000 of gain realized on the sale or exchange of a principal residence. Unfortunately, the House bill diluted this relief and further increased the complexity of the

tax code by introducing a new "alternative minimum tax" imposed at a 10 percent rate on one-half of a noncorporate taxpayer's net capital gains, reduced by a $10,000 exemption. Gains from the sale of a principal residence would not be included. This tax would be paid if it exceeded the taxpayer's regular tax liability. The Chamber opposes the concept of a minimum tax, either in the form of an additional tax, as under present law, or as an alternative tax. This Committee should reject attempts by the Administration to seek retention of the minimum tax on capital gains of corporations and individuals.

The House bill also repeals the 25 percent alternative tax on up to the first $50,000 of long-term capital gains of individuals, a move the Chamber opposes. While it is true that the alternative rate for capital gains of individuals primarily affects a relatively small number of taxpayers in the higher brackets, it must be recognized that it is this group of taxpayers that provides much of the risk capital that keeps our economy growing. The Chamber also opposes any attempt to increase the alternative capital gains rate for corporations.

While the Administration stresses that the initial capital gains tax relief would go to upper income families, they fail to state that, first, taxpayers are driven into upper income brackets when they must sell an asset (for example, a residence, small business or family farm) and, second, that the initial offsetting increases in tax receipts will disproportionately come from upper income families.

Also, in time, the greatest growth of investment, jobs and incomes will disproportionately benefit middle and lower income families, because a large proportion of the $8 billion of additional wages and salaries generated will be paid to semiskilled and unskilled workers as the economy continues to grow.

Over 70 percent of the growth of GNP is for labor income. Therefore the President should have said that more than half of the total benefits of capital gains tax relief would accrue to middle and lower income families, although it may appear initially that tax relief is being given to middle and upper income families. The President is wrong to state that only "'two-bits" or 25¢ goes to middle and lower income families. Capital gains tax relief clearly helps the disadvantaged, older people, minorities, women, and teenagers, as well as other Americans in other economic and demographic conditions.

DEPRECIATION

Inflation has struck even more severely at capital goods than at personal consumption expenditures. Since 1972, implicit price deflators have risen 75 percent for residential and 56 percent for nonresidential fixed investment, compared with 49 percent for personal consumption expenditures, and 51 percent for GNP as a whole.

This rapid inflation makes modernization and expansion of plant and equipment difficult to finance. The difficulty is compounded by outmoded "useful lives" which must be used for depreciation tax purposes and by limitations on depreciation methods. The concept of prompt capital recovery allowances designed to encourage replacement and expansion should take the place of outmoded concepts of useful lives, which are being used unsuccessfully in the attempt to measure depreciation and obsolescence.

The present depreciation provisions in our tax laws are inadequate and in great need of overhaul. The codification in 1971 of the Assets Depreciation Range (ADR) system, which the Chamber supported, represents an important step in encouraging investment and replacement of obsolete and inefficient machinery and equipment, increasing productivity, fighting inflation, encouraging economic growth to provide jobs, and maintaining American leadership in the world marketplace.

As a first step toward overdue depreciation reform, the ADR system should be liberalized to provide for a 40 percent variable capital cost recovery period applied to the 1962 Treasury guidelines. At the same time, we reaffirm our long-standing belief that the goal of depreciation reform should be a complete capital cost recovery system that groups assets in a few general classes, to which a capital cost recovery percentage is applied to assets as a class.

DOUBLE TAXATION OF CORPORATE INCOME

It is the view of the National Chamber that the double taxation of corporate income should be eliminated.

Corporate income is the only form of income that is subject to two Federal income taxes—at the corporate level at a rate of 48 percent, and, when received

as a dividend by an individual shareholder, at the individual's tax rate. This double taxation of corporate income is wholly contrary to the equitable concepts on which a tax system should be based.

High tax rates emphasize the unfairness and unsoundness of the double taxation of equity capital which results from the taxation of corporate earnings and of corporate dividends received by individuals. The National Chamber has opposed the double taxation of corporate income for many years. This inequity in the tax laws should be corrected.

In 1954, in an effort to mitigate double taxation, Congress passed a $50 dividend exclusion coupled with a nonrefundable tax credit equal to four percent of dividends received in excess of $50. In 1964, the $50 exclusion was raised to $100, but the tax credit was eliminated. No further relief from double taxation has been granted, even though inflation has driven down the value of the exclusion to the point that an exclusion of over $200 today would be comparable to the $100 exclusion at the time it was adopted in 1964.

The corporate form of business enterprise allows for the efficient concentration of the capital of large numbers of investors, and provides limited liability for investors. However, it is the only form of business enterprise whose owners are subject to double taxation.

Double taxation of corporate income dramatically increases individual income tax rates. An individual in the 20 percent tax bracket in effect pays 48 percent at the corporate level and then an additional 20 percent on what is left, for a total tax burden of 58.4 percent. This is nearly three times that individual's rate.

The double taxation of corporate income creates problems in raising equity capital. When a potential investor assesses the attractiveness of an investment opportunity from the variety available to him, he must consider the potential after-tax return. Because of double taxation, the rate of return on an investment in corporate stock must be higher than that on other types of investments not subject to double taxation.

When a corporation seeks additional financing, it may sell new shares of stock or it may borrow money through debt financing. The interest on debt is tax deductible, while dividends are subject to double taxation. This creates a bias toward the use of debt financing by corporations. Increased debt means increased risk since corporations in these circumstances must meet higher fixed costs for interest and face greater risks of bankruptcy.

Eliminating double taxation of corporate income would offer an incentive to more people to invest in American enterprise. It would have a positive impact on business, on the securities markets, on capital formation, on jobs, and on the overall economy.

SMALL BUSINESS TAX RELIEF

SUBCHAPTER S

The House-passed bill contains several amendments to the Subchapter S provisions of the Internal Revenue Code designed to facilitate the use of these provisions by closely held businesses. Under Subchapter S, the income of a qualifying corporation is taxed to its shareholders, whether it is distributed as a dividend or retained by the corporation, and the shareholders are allowed to deduct the corporation's losses to the extent of their basis in the corporation's debt or equity. Subchapter S treatment is available only to corporations with a small number of shareholders engaged in an active business.

H.R. 13511 liberalizes several rules governing treatment of a small business corporation under Subchapter S. The bill increases the permitted number of shareholders to 15 in all situations and relaxes certain other restrictions on the shareholders of a Subchapter S corporation. It also expands the period of time to make the Subchapter S election to include the entire preceding taxable year of the corporation.

The National Chamber supports these efforts to liberalize the present tax treatment of Subchapter S corporations.

SMALL BUSINESS STOCK

Under present law, an individual sustaining losses on the sale or exchange of certain small business stock ("Section 1244 stock") can treat $25,000 of such losses as ordinary income, rather than as capital losses. The limit on ordinary losses on Section 1244 stock in the case of married taxpayers filing a joint return is $50,000.

Section 1244 stock is common stock issued to an individual or a partnership pursuant to a plan by a corporation which qualified as a "small business corporation." In the five years before the taxpayer incurs loss on the stock this corporation must derive more than 50 percent of its aggregate gross receipts from active business operations. A small business corporation is one whose total equity capital does not exceed $1,000,000, and which did not receive over $500,000 as contributions to capital and paid-in surplus on the issuance of its stock.

H.R. 13511 liberalizes the rules relating to Section 1244 stock, to provide greater incentives for investment in small business corporations. The Chamber supports this more favorable loss treatment for small business stock issued under Section 1244 of the Internal Revenue Code.

Under the House bill, individuals who experience losses on small business stock would be able to treat $50,000 ($100,000 on a joint return) of such losses per taxable year as ordinary losses which can be used to offset ordinary income, rather than as capital losses. The equity capital limitation of $1 million would be repealed, and the permissible amount of Section 1244 stock which a corporation may issue would be increased from $500,000 to $1 million. Technical restrictions, such as requiring the adoption of a written qualifying plan, would be eliminated.

Section 1244 was added to the Code as part of the Small Business Tax Revision Act of 1958. The House Committee Report explained that this provision was designed to encourage the flow of new funds into small business by reducing the risk of loss for such new funds.

One of the greatest problems smaller businesses face today is the acquisition of sufficient capital for growth and expansion. Section 1244 has remained substantially unchanged since its adoption almost twenty years ago. The dollar limits in this section should be increased in recognition of the impact of inflation.

DEPRECIATION FOR SMALL BUSINESS

The present depreciation provisions in our tax laws are inadequate, still tied to an outmoded system of useful lives, and in great need of simplification and overhaul. Liberal capital cost allowances are especially important to small or new businesses which have difficulty in obtaining capital for long-lived property.

Of particular interest to these enterprises is the provision of the tax law which permits additional depreciation to be taken in the first year of an asset's life, and which was enacted to provide a special incentive for small businesses to make investments in depreciable property. In addition to the regular deduction for depreciation, taxpayers may elect to take an initial deduction of up to 20 percent of the cost of certain tangible personal property. This extra 20 percent deduction applies only to the first $10,000 of investment ($20,000 for individuals filing joint returns). To be eligible for additional first-year depreciation, property must have a useful life of six years or more. The House bill increases the allowable additional first-year depreciation percentage to 25 percent and increases the dollar limitation to $20,000 ($40,000 for joint returns) but it limits the use of additional first-year depreciation to taxpayers with depreciable assets whose adjusted cost basis at the beginning of the taxable year is less than $1 million. While the Chamber supports the increase in the dollar limit, the qualifying useful life of assets should be reduced and this provision should remain available to all taxpayers.

INDUSTRIAL DEVELOPMENT BONDS

Under present law, the interest paid on industrial development bonds issued by a State or local government is tax exempt where such bonds provide revenues for certain exempt activities such as air or water pollution control facilities and industrial parks, or where they are issued within the scope of a "small issue" exemption. Small issues limited to a face amount of $1 million or less qualify for exemption, and at the election of the issuer may be increased to $5 million if all capital expenditures on the financed facility over a six year period do not exceed this amount.

The House bill increases from $5 to $10 million the amount of the limitation on the size of the small issue election for tax-exempt industrial development bonds. It is the view of the Chamber that the maximum face amount permitted under the small issue exemption should be increased and the time period restrictions should be removed.

Industrial development bonds provide many companies with the opportunity to finance new plant facilities in areas where it would otherwise be unprofitable to

do so. These bonds can create jobs and improve the tax base of a community. They are essential to bring industry to many areas of the country which need employment opportunities for their citizens. Since Congress established the maximum face amount in 1968 and 1969, the cost of industrial development has greatly increased, in large part as a result of inflation. The present ceiling on industrial development bonds should be raised to restore the effectiveness of this important provision.

Industrial development bonds also provide opportunities to construct facilities to reduce pollution. Congress has recently demonstrated support for tax measures which promote the public policy goal of pollution control, recognizing the increased capital costs this activity generates. Industrial development bonds provide an important source of financing for this important task. Repealing the exemption for these bonds, as the Administration has proposed, would seriously impair the ability of local governments to provide assistance to businesses in cleaning up the environment.

EMPLOYMENT TAX CREDIT

The National Chamber supports the proposed targeted employment tax credit because it will help refocus federal employment policy on the structurally unemployed and away from public job creation toward private sector jobs. Our support for the tax credit is consistent with our recent position to redirect the Comprehensive Employment and Training Act (CETA) toward these same two objectives.

H.R. 13511 would replace the general jobs credit due to expire at the end of this year with a targeted jobs credit of 50 percent of Federal Unemployment Tax Act (FUTA) wages per individual ($3,000 maximum) the first year, and 16⅔ percent ($1,000 maximum) the second year for hiring: (1) Aid for Dependent Children (AFDC) recipients who register for the WIN program; (2) handicapped individuals; (3) 16 to 18 year-olds who participate in high school or vocational school work/study programs; (4) individuals aged 18 through 24 who are members of households receiving Food Stamps; (5) Supplemental Security Income (SSI) recipients; (6) Vietnam veterans who are members of households receiving Food Stamps; and (7) recipients of general asssistance for 30 days or more. Wages eligible for the credit would be limited to 30 percent of the total FUTA wages paid by an employer.

In recent months the United States private economy has grown dramatically. Over 6.4 million jobs have been created in the past 18 months. At the same time, overall unemployment has declined, dropping from 7.3 to 5.7 percent in June and back up to 6.2 percent last month. Yet, during this period unemployment rates for teenagers and young adults have remained far higher than the rates for the overall labor force. In June, when the overall unemployment rate dropped to 5.7 percent, the black unemployment rate was 11.9 percent, the teenage rate was 14.2 percent and minority youth, aged 16-19, had a 37.1 percent unemployment rate. It is among these groups that structural employment problems persist. These groups should be the primary focus of federal employment programs.

Structural unemployment problems will be solved only in the private job market where the bulk of permanent unsubsidized jobs exist. The targeted employment tax credit is one mechanism—among many—which should be used to provide economic incentives to encourage private sector hiring of the hard-core unemployed. Other mechanisms to facilitate private sector hiring include direct contracts for training and employing the disadvantaged, a youth differential in the minimum wage and a payroll tax offset. The targeted tax credit should be one component of a multifaceted approach toward greater emphasis on private sector training and jobs program for the structurally unemployed.

INDIVIDUAL TAX RELIEF

The National Chamber favors tax relief for individuals totaling $17–$20 billion in 1979. Relief of this magnitude is necessary to overcome the tax increases caused by inflation and by the rise in social security taxes passed by Congress last year.

Such relief should go to all taxpayers. For that reason, the Chamber applauds the approach taken by the House granting across-the-board relief, although the individual cuts of $10.4 billion voted by the House do not go far enough.

Personal income tax cuts of course increase disposable income and thereby increase consumer spending which in turn provides jobs for those who produce, sell, and service consumer products. These activities all lead to some revenue feedback.

What is less widely appreciated is that personal tax relief also directly helps small business remain competitive and increase employment and investment. This

is so because roughly 85 percent of small businesses pay tax through the individual income tax, as proprietors, partners, or Subchapter S corporations.

It is important that personal income tax relief be directed at all income levels. We are pleased that the House has chosen to provide such across-the-board relief by expanding the tax brackets and by replacing the present general credit and $750 personal exemption with a $1000 personal exemption. This is a far more satisfactory approach to tax relief than the $240 credit which the Administration has urged. In fact, the House bill yields remarkably evenhanded relief across income classes, averaging 5.6 percent of tax under present law. According to the Report of the House Ways and Means Committee on H.R. 13511, relief ranges between 3.7 and 6.3 percent of tax under present law, depending on size of income. Thus the distribution of individual tax relief in the House bill is fair, but the overall amount should be increased significantly, from $10.4 billion to $17–$20 billion.

TAX TREATMENT OF ITEMIZED DEDUCTIONS

H.R. 13511 would limit the availability of certain itemized deductions to individual taxpayers. The Chamber's response to the suggested changes in specific itemized deductions is set out below.

DEDUCTION FOR NONBUSINESS TAXES

Under H.R. 13511, State and local gasoline taxes would no longer be deductible. In addition, the Administration has renewed its intention to seek the elimination of deductions for general sales taxes, personal property taxes and miscellaneous taxes. The National Chamber opposes any changes in the tax law that would eliminate or abridge the present deduction for nonbusiness taxes.

State taxes on gasoline are generally used to finance roads and highways. Eliminating the deduction for State gasoline taxes paid would encourage State and local governments to rely on other taxes that are deductible for Federal tax purposes, such as income and property taxes, to meet additional expenditures for highways and roads.

By not permitting Federal income tax deductions for State and local personal property taxes, sales taxes, and gasoline taxes, the Federal Government loses its neutrality as to the various methods by which State and local governments raise tax revenues. Eliminating the Federal tax deduction for general sales taxes would encourage State and local governments to place a greater reliance on deductible income and real property taxes. Present law recognizes that payment of the various State and local taxes reduces a taxpayer's ability to pay Federal taxes. Retaining the deduction for all nonbusiness taxes paid would guard against the possibility that an individual's Federal, State and local taxes combined could exceed that taxpayer's gross income.

DEDUCTION FOR MEDICAL EXPENSES

The Internal Revenue Code permits a taxpayer to claim itemized deductions for medical and dental expenses which exceed three percent of the taxpayer's adjusted gross income. An individual may also claim a deduction for the lesser of $150 or one-half of amounts paid for medical insurance. Medical insurance premiums not eligible for separate deduction are counted in calculating the expenses subject to the three percent limitation.

Under the House bill, the deduction for medical expenses would be revised to permit taxpayers to deduct only medical and prescription drug expenses, including insurance premiums, that exceed 3 percent of adjusted gross income.

The National Chamber supports retention of the present medical expense deduction which recognizes that a family with significant medical expenses has a reduced ability to pay income taxes compared to a family that has the same income but few medical expenses.

POLITICAL CAMPAIGN CONTRIBUTIONS

Under current law, an individual taxpayer who makes certain political contributions can elect to take either an itemized deduction of up to $100 for a single return ($200 for a joint return), or a tax credit for one-half of the contributions, up to a maximum credit of $25 ($80 in the case of a joint return). The House bill would eliminate the deduction for political contributions, but retain the tax credit.

The National Chamber supports the availability of reasonable tax deductions and tax credits for political campaign contributions. Our democratic process is based on popular choice. The availability of tax deductions and tax credits encourages individuals to make voluntary contributions to the candidates of their choice, thus promoting greater interest and participation in the election process.

DEFERRED COMPENSATION

H.R. 13511 provides rules under which employees and independent contractors performing services for state or local governments or tax exempt rural cooperatives will be able to defer annually an amount equal to the lesser of $7,500 or 33⅓ percent of their compensation under nonqualified deferred compensation plans. Essentially, this continues the present law with one change; the addition of prescribed annual limitations upon the contributions that can be elected by the employee.

H.R. 13511 also would make certain that the tax treatment accorded unfunded nonqualified deferred compensation plans maintained by taxable entities prior to February 3, 1978 would be maintained. We welcome and support this step to correct the uncertainty of the tax status of these plans which resulted from proposed Treasury Regulations issued on February 3, 1978. One question that remains, however, concerns the tax status of deferred compensation plans maintained by non-profit organizations, since H.R. 13511 addresses only plans maintained by governmental and taxable entities. We hope the Committee will clarify this point.

We are also concerned by proposals to subject contributions to deferred compensation plans maintained by taxable entities to Section 415 limits. The effect would be most troublesome since many such plans include participants whose combined benefits from qualified and nonqualified plans exceed these limits. Adoption of such a proposal could cause many of these plans to terminate, leaving all participants with reduced retirement income protection. We believe current law is sufficient to protect revenue loss and we urge the Committee not to accept additional limitations.

CAFETERIA PLANS

Under present law employees can exclude from gross income certain medical, disability and group-term life insurance benefits provided by their employer while the employer may deduct the costs for maintaining these employee benefits without regard to whether some of the employees benefit more than others. Retirement plans, supplemental unemployment benefit plans and group legal service plans, on the other hand, do not receive favorable tax treatment if they discriminate among employees. H.R. 13511 proposes to continue the current exclusion from an employee's taxable income of the value of these benefits only where the benefit plans meet participation rules designed to prevent discrimination in coverage and benefits provided. The ability of the employer to deduct expenses of employee welfare plans would not change.

Extension of the nondiscrimination principle to cafeteria plans could have far-reaching disruptive effects since control over the distribution of the benefits under these flexible plans is left with the employees.

OTHER TAX REVISION ITEMS

The Chamber's view on additional tax revision items that could figure in this Committee's deliberations are set out in the following pages.

TAXATION OF CONTROLLED FOREIGN CORPORATIONS

The Administration proposed last January to phase out "tax deferral" of earnings of U.S.-controlled foreign corporations over a three-year period. The House Committee on Ways and Means heard many witnesses on this proposal, but declined to include it as part of H.R. 13511.

The Chamber opposes any changes in the tax law that would permit taxing earnings of foreign subsidiaries of United States corporations in the year in which they are earned, rather than when they are paid to the parent company as dividends, as at present. Sound reasons exist for the present tax law. Any change almost certainly would curtail U.S. foreign operations, with an attendant loss of American jobs both here and abroad.

Foreign corporations generally are subject to tax by the United States only to the extent they conduct a trade or business in the United States or derive invest-

ment income here. Thus, the United States at present does not impose a tax on the foreign source income of a foreign corporation. The foreign source earnings of a foreign corporation as a general rule are subject to U.S. income tax only when they are actually remitted to U.S. shareholders in the form of dividends, and the tax is imposed on the U.S. shareholder and not on the foreign corporation. The fact that no U.S. tax is imposed until, and unless, the income is distributed to the U.S. shareholders is referred to by some as "tax deferral."

A significant exception to the general rules regarding U.S. taxation of foreign corporations was enacted in 1962. Under Subpart F of the Internal Revenue Code, certain income of a foreign corporation controlled by U.S. persons that is derived from specific foreign activities is included in the current income of the U.S. shareholders on a pro rata basis, even though this income is not currently distributed. In adopting Subpart F, Congress specifically rejected a general proposal to tax the undistributed income of foreign corporations to their U.S. shareholders.

Taxing foreign subsidiaries on a current basis violates the basic principle of taxation that income should be taxed only when it is received. A change in the law would require either that the United States parent pay U.S. tax on dividends it has not received or that the foreign subsidiary pay dividends to its U.S. parent to help finance the tax the parent has to pay. The effect of either of these would be highly detrimental to the financing of American operations abroad. A foreign subsidiary of a United States corporation is a separate entity incorporated under and subject to the laws of its host country, and must pay taxes to it. The earnings of the subsidiary do not become part of the earnings of its parent until they are distributed. Therefore, they should not be taxed until received.

Increasing the total tax burden on United States companies operating abroad would put them at a substantial competitive disadvantage with foreign companies which are not taxed by their own countries on the earnings of their foreign subsidiaries. Industries which require large reinvestment of earnings for purposes of expansion would be particularly hurt. No other major industrial country subjects the unremitted earnings of the foreign subsidiaries of its domestic corporations to current taxation. In the long run, the only beneficiaries of a United States tax on current earnings of foreign subsdiaries would be our foreign competitors.

Significant amounts of U.S. exports go to foreign companies controlled by U.S. shareholders. The jobs of millions of U.S. workers depend upon these exports. At a time when there is widespread concern about the merchandise trade deficit, it would be a grave mistake to impose this additional roadblock to increasing U.S. exports. Merchandise exports are approaching an annual level of $150 billion. Any tax change which would cost the nation even one percent of these exports would mean a reduction of $1.5 billion in exports and tens of thousands of jobs.

The elimination of "deferral" probably would not increase U.S. tax revenues. It could, in fact, result in reduced revenues. Any increased taxes paid by U.S. businesses operating abroad could end up in foreign treasuries because foreign countries which presently offer tax rates lower than the U.S. rate would probably raise their rates to the U.S. rate. This would be most likely to occur in many of the developing countries where U.S. companies are engaged in intense competition to establish and develop new markets.

The Administration acknowledged last January that "the United States may wish to validate the tax incentives that a developing country offers to U.S. investors," but suggested that this be accomplished by focusing "the benefits of deferral" through the tax treaty program. As a practical matter, however, the negotiation of a tax treaty is a lengthy and time consuming process. More importantly, if the Administration's proposal is adopted, the decisions on the retention of "deferral" so crucial to U.S. taxpayers with operations abroad will rest with the Treasury Department, subject only to ratification by the Senate.

The tax treatment of controlled foreign corporations has been scrutinized closely by Congress in the past several years. Most recently, the Task Force on Taxation of Foreign Source Income, established by the House Committee on Ways and Means during its consideration of the Tax Reform Act of 1976, studied this issue but after analyzing various proposals "decided not to make any recommendations to change the law with respect to the tax treatment of deferred earnings of foreign corporations controlled by U.S. shareholders."

Taxing the earnings of controlled foreign corporations only when they are repatriated is necessary to maintain equality with foreign competition. To currently tax income not yet received by American shareholders could only have

an adverse effect on domestic employment and on our balance of payments, and could seriously weaken our competitive position abroad.

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

The National Chamber supports the concept of a Domestic International Sales Corporation (DISC). The DISC provisions, codified in the Revenue Act of 1971, took effect on January 1, 1972. Since that time, many companies have set up DISCs, thereby utilizing plants in the United States and employing American workers, rather than locating their production facilities abroad. The Administration proposes to eliminate DISC benefits over a three-year period.

A DISC is a special type of U.S. corporation engaged in the business of export sales and related activities. The DISC itself is not subject to income taxes, although its shareholders are treated as receiving part of the DISC's income and taxed currently on the amount of the income even though no distributions have been made. To qualify for DISC treatment, at least 95 percent of a corporation's gross receipts must arise from export activities. In addition, at least 95 percent of the corporation's assets must be export-related.

The Tax Reform Act of 1976 substantially cut back DISC benefits. For tax years beginning after December 31, 1975, the tax deferral on DISC profits is limited to the amount by which its export gross receipts exceed 67 percent of the DISC's average gross receipts in a four-year base period. Until 1980, the base period years are 1972 through 1975. The base period for taxable years beginning in 1980 moves forward each year. DISCs with incomes of $100,000 or less are exempt from this rule, with this exemption phased out for incomes between $100,000 and $150,000.

The DISC provisions have contributed significantly, both directly and indirectly, to the growth of domestic employment related to exporting. Many U.S. companies that now use the DISC mechanism have substantially increased their exports, thus providing more vitally needed U.S. jobs.

Since the DISC legislation was enacted, this country has witnessed a tremendous growth in world trade, high rates of inflation, large increases in the price of oil and other products, floating exchange rates and a recent international economic slowdown. These factors have an effect on evaluating the role of DISC in the growth of exports. Nonetheless, the DISC provisions have encouraged exports, and DISC exports have generally grown at a faster rate than non-DISC exports.

Besides promoting domestic employment, increasing exports, and contributing to the balance of trade, the DISC provisions were intended to overcome two major disadvantages that faced United States-domiciled exporters. First, they were often competing against exporters based in foreign countries, who are given more liberal tax benefits by their governments. Second, domestic exporters were not receiving the tax benefits available to foreign subsidiaries of United States corporations.

Use of a DISC allows firms that are too small to operate through foreign subsidiaries to enter the export field. The use of DISCs continues to increase. Through February, 1977, over 9,400 DISC elections had been made, according to recent Treasury estimates. The tax deferral may not be large in many cases, but the cumulative benefit provides a substantial increase of working capital for further export development.

DEDUCTIBILITY OF BUSINESS EXPENSES

In its testimony before this Committee last week, the Administration renewed its attack on deductions for certain kinds of business expenses. The House bill, however, contains no additional restrictions on the deductibility of these expenses. Attempts to add any during the Ways and Means Committee's deliberations failed.

The National Chamber opposes changes in the tax laws to further restrict the ability of business people to deduct their ordinary and necessary expenses incurred for business meals, business travel, or business entertainment.

A taxpayer generally may deduct all the ordinary and necessary expenses paid or incurred during the taxable year if they bear a reasonable and proximate relation to the taxpayer's trade or business and they are reasonable in amount. Deductible ordinary and necessary business expenses include the cost of meals, lodging, travel, transportation and business entertainment. Under present law, business entertainment expenses are deductible only to the extent that they are

reasonable in amount, directly related to or associated with the taxpayer's business, and not "lavish or extravagant." No deduction is allowed for such expenses unless the taxpayer can substantiate by adequate records or by sufficient corroborative evidence the amount of the expense, the time and place of its ocurrence, its business purpose and the business relationship to the taxpayer of the persons present.

The business meal provides an accepted and important way to conduct business. There is no question that significant business decisions are often made at business meals. Eliminating or cutting back a taxpayer's ability to deduct legitimate business meal expenses will discourage business people from working with customers, suppliers and other people important to their businesses during mealtime.

Turning costs which result from accepted business practices into nondeductible expenses could prove extremely disruptive to the business community. Further, those businesses which engage in providing services, such as restaurants, hotels, their suppliers and related industries will be severely affected by new restrictions on business deductions.

Admittedly, some abuses occur in the area of deductions for business expenses. But such incidents should not be used to support changes which will penalize business people who do not engage in these questionable practices. Present law prohibits deductions for unnecessary expenses or for items that are lavish and extravagant. Stricter enforcement of present law is the proper way to deal with those taxpayers who abuse the system by deducting nonlegitimate expenses as business expenses.

Proposals to further limit business deductions represent substitution of governmental judgment for the judgment of the individual as to what constitutes a necessary and proper expense of doing business. The Chamber believes that present law should be retained.

"AT RISK" LIMITATION ON DEDUCTIONS

The Tax Reform Act of 1976 added two "at risk" rules to the Internal Revenue Code. One rule, the "specific activity at risk rule," applies to all taxpayers except corporations which are neither Subchapter S corporations nor personal holding companies. This rule covers four specified activities: producing and distributing motion pictures, farming, equipment leasing, and exploring for oil and gas. It limits the amount of a loss which may be deducted to the amount with respect to which the taxpayer is "at risk" in the activity which gave rise to the loss.

The other "at risk" rule is known as the "partnership at risk rule." It applies to all partnership activities other than real estate and those to which the specific activity at risk rule applies. In general, a partner may deduct his share of the partnership loss, but only to the extent of his adjusted basis in the partnership. The "partnership at risk" rule requires that, for those activities to which it applies, in determining the limitation on losses which may be taken by a partner, the adjusted basis shall not include any portion of any partnership liability with respect to which the partner has no personal liability.

The House bill would extend these "at risk" provisions to all activities (except real estate) carried on individually, through partnerships, by corporations more than 50 percent-owned by five or fewer persons, by Subchapter S Corporations or by personal holding companies.

A limitation on deductions based on the amount the taxpayer is "at risk" complicates the tax law and places taxpayers who must resort to nonresource financing to make investments at a competitive disadvantage in relation to taxpayers not forced to borrow. This inequality of treatment could discourage taxpayers who might otherwise make leveraged investments from making those investments. The Chamber believes the "at risk" provisions should be removed from the tax law.

TAXATION OF UNEMPLOYMENT COMPENSATION

The National Chamber opposes the provision of H.R. 13511 which would subject unemployment compensation (UC) and disability benefits to taxation.

Under the House bill, there would be included in annual taxable income one-half the excess of the sum of (a) the taxpayer's adjusted gross income, (b) all UC benefits and (c) all disability income received as a substitute for unemployment compensation pursuant to State unemployment disability plans over (d)

the taxpayer's "base amount." The base amount is $25,000 for married individuals filing a joint return; zero for a married individual filing a separate return (unless living apart from spouse for entire taxable year); or $20,000 for all other individuals.

There are a number of problems with the taxation of UC benefits, and until these problems are deliberated at length, the Congress should defer action on this issue. The National Commission on Unemployment Compensation, which was appointed to study issues of this nature, should be given an opportunity to provide guidance to the Congress before final action is taken.

Some of the questions that arise in connection with subjecting unemployment compensation to the Federal income tax are set out below:

Will such a change lead to the taxation of other social insurance benefits such as workers' compensation, social security, or welfare benefits currently not subject to tax? We think so, yet there has been almost no public discussion of the question.

How will this income be reported to tax authorities? By state agencies or by employers? H.R. 13511 is silent on this point but we must note that employers would face a most costly and complex task if they are required to report these data.

Does this not introduce a needs test for unemployment compensation, whereas the system is based on an earned right?

What is to stop States from raising benefits to offset the impact of the tax?

Is there really a work disincentive for high income persons and not for low income workers for whom unemployment compensation benefits replace as much as three-fourths of wages?

Moreover, job decisions are premised upon immediate income (i.e. weekly) rather than aggregate annual income.

How then will this change influence a person's practical considerations on whether to accept employment?

We support continuation of present law regarding the income tax treatment of unemployment compensation benefits, and we recommend that Congress defer action until the final report of the National Commission on Unemployment Compensation becomes available and there has been an opportunity for adequate public debate on the issue of taxing transfer payments.

PAYROLL TAX CREDIT

During its deliberations over H.R. 13511, the House Committee on Ways and Means considered and rejected a proposal that would have allowed employees, self-employed persons, and employers to receive a refundable income tax credit equal to 5 percent of payroll taxes paid for 1979 and 1980. While we are sensitive to the massive increases scheduled in Federal Insurance Contribution Act (FICA) taxes, the Chamber strongly opposes this type of approach to social security tax relief, since it would use general revenues to finance social security without any positive impact upon the long range financial integrity of social security trust funds.

The CHAIRMAN. Now we will call Mr. Alan Greenspan, and he is scheduled to testify for 10 minutes.

We are very happy to have you with us, Mr. Greenspan. We welcome your statement this morning.

STATEMENT OF ALAN GREENSPAN, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I very much appreciate the opportunity to testify on H.R. 13511. It is a good bill, as far as it goes, perhaps the best that has come out of the Ways and Means Committee in years. Yet I believe it fails to address a need for a longer term tax and more generally fiscal policy. This, in my judgment, calls for a phased reduction over a period of years, such as is embodied currently in the Roth-Kemp bill.

I would best describe the Nation's key problem is that we have an underlying rate of growth in Federal expenditures that threatens to outstrip our capacity to effectively finance it. Year after year we continually revise upward our long-term current services budget projection to reflect ever-expanding programs.

This implies a growth rate in outlays at least as great as GNP.

If we tried to finance this underlying growth in outlays through taxes, the tax burden would eventually become intolerable, undercut incentives, and stunt economic growth. The weakened economy would surely lead to a reduction in the tax base, a consequent inability to finance real Federal expenditure growth and hence chronic inflation. Alternatively, if we do not allow the share of GNP going to taxes to rise, our already huge deficit would widen and create an intolerable inflationary environment.

The inflation threat, therefore, is not on the receipts side, but on the expenditure side. Unless we find a means of curbing the growth in outlays, there is no tax policy which will prevent the onset of chronic inflation.

The only way we can break the upward trend of outlays is to curb the long-term growth in revenues. Under existing tax law and given the progressive nature of our income tax structure, revenue growth would be extremely large. If tax rates are not cut periodically, the real tax burden would soon become intolerable. Hence, taxes have to be cut, and surely will be, over the next several years.

But it is important that we specify those cuts in advance so that expenditure programs can be tailored to available revenues. We need to preempt a significant part of the fiscal dividend for future tax cuts. If we do not, new expenditure programs will readily absorb them.

We must be careful not to be misled by the seeming evidence of expenditure restraint attributable to outlays falling short of estimates. This shortfall has plagued us for the last 2 years, and there is a risk of our being mesmerized into expecting the shortfalls to continue. Let's not forget that budget authority has been granted, and it is largely the translation of authority into outlays which has been faulty. For a Federal agency to indefinitely eschew spending money for which it has authority, verges on the mind boggling.

Accordingly, it would be risky to presume that the budget of the United States is somehow under control. The evidence suggests that it is not. There is still a built-in momentum to new program creation and expansion. The major problem is the rise in the main segment of the budget: payments for individuals.

This category, currently accounting for 43 percent of total spending, includes all forms of welfare and retirement incomes—that is, social security, medicare, government retirement, et cetera.

In real terms, that is adjusted for inflation, these outlays have grown at a relatively steady annual rate of 8.5 percent since the middle of the 1950's far in excess of the growth rate of the economy and, certainly, far in excess of the growth in our taxing capacity. So high a growth rate did not matter when the base was small. It had little effect on the growth in total outlays in the 1950's.

By 1968, however, payments for individuals had risen to one-fourth of total budget outlays—from 19 percent in 1955.

Although they grew at a 10-percent rate during the period 1968 through 1976, the effect of these expanding programs on the total budget was obscured by a significant decline in real defense expenditures. As a consequence, total budget outlays during that period grew at only a 1.9-percent annual rate in real terms. But by fiscal 1976, the decline in defense had gone about as far as it could. Defense outlays have recently begun to edge up in real terms. As a result, the continued rise in payments for individuals and other growing nondefense outlays are now beginning to have their full effect on the aggregate budget.

Hence, the outlook for Federal expenditures rests largely with curbing the growth in payments for individuals. On a current budget basis, these outlays are projected to grow in real terms at only a 3.5-percent rate over the next 5 years. However, recent history indicates that in this area more than in any other, current services are consistently expanded and that this is largely the cause of the outsized real growth rate in these outlays.

In this respect, the current services budget does not appropriately reflect the current institutional pressures, since the Congress meets virtually all year long and in the process creates add-ons which are reasonably forecastable in advance in total, if not in detail. So long as committees meet on recommended legislation, increased budget authority seems inevitably to emerge. It is a rare session that produces little in the way of either new programs or add-ons to existing ones.

This would not be a problem if the underlying growth rate of the American economy were even close to the 8.5-percent growth rate in payments for individuals. But it is not, and there is no credible scenario by which it conceivably could be brought there. Hence, there is no alternative to pulling back the aggregate growth in Federal expenditures.

It would be unrealistic to expect any significant expenditure retrenchment from zero-based-budgeting exercising. There is always some group of individuals in the electorate whose voting behavior is perceived as being wholly dependent upon developments in a specific Federal program. Hence, while the President may have his own program priorities, which he and his associates are clearly capable of arraying by degree of urgency, it is a rather different set of priorities than one would obtain from attempting to trade off the intensity of priorities exhibited by so-called special interests.

What we tend to end up with after a rigorous exercise in zero-based budgeting is the concensus that political groups and interests cannot be arrayed and traded off in a manner consistent with an appropriate set of national priorities. The budgetary system, both in the administration and in Congress, despite the formation of the Budget Committees, is poorly equipped to handle this problem.

It is clear, granted the continued momentum of expenditure growth, that the budget committees by themselves will not be able to accomplish the required restraint in outlays that this Nation so sorely needs. Ultimately, we will probably need, perhaps through a constitutional amendment, a rigid limitation on expenditure growth. It is only in that manner that sufficient long-run barriers to programmatic growth seems possible.

In the interim, it appears that a limitation can be initiated only from the receipts side of the budget. A reduction in the momentum of expenditure growth can be accomplished by restraining the revenues available and trusting that there is a political limit to deficit spending. I believe that there is such a political limit and it seems to be getting smaller by the day.

The Budget Committees are going to need a major assist from those of you who are responsible for the raising of revenues. In my judgment, the Committee on Finance, by initiating a tax cut such as Roth-Kemp—in which tax rates are gradually lowered over a three-year period but announced in advance—can play an important role. This would effectively set a general limit on expenditures which the Senate Budget Committee could implement to constrain the normal evolution of expenditure programs.

Thank you, Mr. Chairman.

Senator MOYNIHAN. Senator Danforth?

Senator DANFORTH. I have not noticed that Congress in the past has been specially restrained to keep spending within the limits of revenues. Last week, Senators Bellmon and Proxmire and I introduced a proposal which would set a goal limiting the growth of Federal spending and impose a surcharge on the income tax to recover the difference.

I do not know if this is the first you have heard about it, but the theory of it is to provide some political constraints against just spending everything in sight, that if Congress were to provide that Federal spending could increase by the amount of inflation, plus 2 percent real growth per year, that within about 5 years the percent of GNP—Government spending as a percent of GNP—would be reduced below 20 percent.

And this would not absolutely prohibit from spending more than a 3-percent increase, but it would simply say to the politicians, look, there is going to be a separate item on the income tax return next April, a surcharge to pick up any overage of that 2 percent, and you are going to have to go back to your constituents to explain why that separate item is on the income tax return.

So would it be, in your opinion—I have never talked to you about this before—would it be desirable or not to join with a significant tax cut in this bill some sort of disincentive, such as Senator Bellmon and Proxmire and I are talking about, to lower this rapid increase on Federal spending?

Mr. GREENSPAN. Senator, I would certainly subscribe to your general proposal. I must say that I wish you well. If you can conceivably implement it, it would be a great service to this country.

I am marginally skeptical because I have seen, over the years, the impact of attempted constraints of this sort go by the way when you begin to confront the underlying question of which individual items would be constrained and under what conditions. I do think, however, that there is no question that the underlying environment in this country for such a measure has improved extraordinarily in the last 6 or 9 months. I think the American people have evidenced an extraordinary reaction to inflation, stagnation, low productivity, a shortage of economic growth, and basic standards of living, and they are saying, something is fundamentally wrong.

As an economist, I say what is fundamentally wrong is that our fiscal policy has gotten offtrack. There is not only one way to restore it, and I would certainly say that if you were capable of convincing your colleagues that that was the right route and they implemented it, it would make a major difference.

I think that there are numerous other ways of doing it, and at the moment, in my view, the most immediate practical way to at least get the process in place is something similar to what Senator Roth and Representative Kemp initiated. The main key, as I see it, is to preempt the revenues that would be generated to the progressive income tax over the years through inflation and, if we can do that, that will signal our expenditure creating system that it has to go slow.

I do not think that there is necessarily a contradiction between your position and the one I am taking.

The CHAIRMAN. Mr. Greenspan, quite apart from the principal thrust of your statement about Government spending, there is this further problem about counterproductive taxation.

A previous witness, in parts of his statement that he was unable to read because of time limitations, says that in his view it is confiscatory to tax more than 50 percent of someone's income. But while some may not agree with that, I think that everyone may agree that there comes a point where the tax is counterproductive.

Let us just take the existing rates that we have, where a person is in a tax bracket of 70 percent and has State income tax along with that. That gets the tax rate up to 75 percent.

If the people are doing pretty well, they might not feel like taking a risk if they can keep only 25 percent of their gain, and furthermore, they do not feel like working 12 months out of the year if they can only keep about $1 in $4 of what they are making by the extra effort. They are making enough where they can do pretty well.

In addition to that, it tends to force the investments in an area where you do not want them. My calculation indicates that a 6 percent tax-exempt bond is a better investment than an investment in stock unless that company is making about a 36 percent profit before taxes.

If you look at the corporate income tax to be paid, and then you look at the personal income tax to be paid, it works out that it would take about a 38-percent earnings on the investment paid on through in order to make it sufficiently profitable compared to what one would have with a tax-exempt bond. And also where one can find a tax shelter, the tax shelter is a far better investment than the kind of investment that we really want people to put their money in, taking a risk to create new jobs, new enterprises, help make business more efficient, and make this economy move.

What can you offer us as a suggestion to make the tax rates and the tax system something that would help channel investment into new enterprises and keep our most able and knowledgeable and successful people working at least 11 months out of the year instead of much less than that?

Mr. GREENSPAN. I could not agree with you more. We have a fundamental problem here which is essentially a value question, not a statistical question.

The value question, I believe, is a question of tax equity. All of us have different views of what is equitable. I would even leave that aside for a moment.

From what we can gather at this stage from the data, which are quite fragmentary, to the extent that our tax structure creates disincentives for investment, what we are doing, in effect, is lowering the standards of living of those most marginally committed to the economy. It is no question, in my judgment, that if we were to very significantly cut the tax rates in the upper income brackets and add the changes discussed for capital gains from the statistically static analysis approach you were referring to, earlier the immediate beneficiaries seem disproportionately to be those in the upper incomes. In fact, it is fairly evident that those that basically gain the most, following the secondary and tertiary analysis of the impact are those who are marginally employed.

They are those when the economy is expanding most who have increased job opportunities, upgraded salaries, increased incomes.

It strikes me immediately that it is terribly shortsighted in all respects to take this naive approach to the analysis of equity and the impact that various tax structure changes have on progressivity. Progressivity, in my mind, has become terribly counterproductive in our tax system. Its underlying purpose is to somehow help the middle- and lower-income groups essentially. The direction of the data, as I said, Mr. Chairman, suggests the opposite.

Unfortunately, definitive proof of these types of statements can only be done in retrospect, perhaps 3 years after the problems emerge and prove to be insoluble—at which point it is probably too late to reverse it.

The CHAIRMAN. Thank you very much.

Senator Packwood.

Senator PACKWOOD. Alan, there are two arguments you made for the tax cuts. One is the argument made by most of the witnesses we have had to date that the capital gains tax will actually increase the revenue. You can get arguments pro and con on that, and also increasing depreciation. What you are saying, second, is that it would be a good thing to adopt something like Roth-Kemp, assuming the projections were such that we note an overwhelming immediate loss, it would be a good thing for the Government to know in 1982 it would have $75 billion less revenue than it would otherwise have without the tax cut and that there is an inherent deficit beyond which we will not go.

If we have $600 million less revenue, we might spend $700 million and if we had $500 million revenue we might spend $600 million. Is that roughly what you are saying?

Mr. GREENSPAN. Yes, sir.

Senator PACKWOOD. Then you are basically endorsing the Roth-Kemp bill apart from any other endorsement that you might have for capital gains or corporate taxation?

Mr. GREENSPAN. Yes; Senator, I testified to the Subcommittee on Taxation and Debt Management of this committee last month to that effect.

Senator PACKWOOD. I have no other questions, Mr. Chairman.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. I shall peruse your statement and I am sorry that I was not here for all of it.

I noted with a great deal of interest your suggestion that we probably will have to come to some sort of constitutional restraint to curb spending, particularly deficit spending.

It has been your observation that that has been successful in reference to State governments, has it not?

Mr. GREENSPAN. Yes, sir, it has been.

Senator CURTIS. And here is one other point that I think should be stressed, that it can well be said that what we need is office holders who are determined and courageous enough to balance the budget and set our house in order.

That is well and good and very desirable, but without a constitutional restraint what office holders can do that? You can have a very careful and conscientious administrator of our financial matters, for a number of years, and have the political pendulum swing the other way and one 2-year Congress could set in motion a great many new programs that become very costly after they have been in for a few years. Do you agree with that?

Mr. GREENSPAN. I certainly do, Senator. Let me just say in retrospect, to amend my answer to your previous question. I would say in general constitutional amendments at State levels have succeeded. I unfortunately can think of one particular case and perhaps two or three in which it has not.

Senator CURTIS. Do you agree with the idea that a constitutional restraint would protect us, particularly during that period where the political pendulum swung in such a manner that a rather extravagant Congress and President might be in office?

Mr. GREENSPAN. Yes, sir. I would like to broaden the issue somewhat in that I would not use the word "extravagant" on the issue, largely because it would seem that all we need to resolve the problems would be "less extravagance." I would grant that our institutional structure is such that we can very easily create an intolerable level of Federal outlays in a context of what might be perceived as constraint.

The difficulty is that as we go through our regular processes of evaluating new programs spanning these periods, the pressures building up are extremely difficult to deal with, largely because when you are looking at the individual bills, the benefits so obviously to most Members of the House and Senate exceed the costs, and it is very difficult to say no" until you try to add these up.

Now, I think the Budget Committees in both the House and Senate have unquestionably had some restraining effect, but in my judgment, nowhere near enough, and it is perhaps either a constitutional amendment or something similar which would probably be required to maintain the degree of restraint which probably is required even in the context of a Congress whose basic purposes are to restrain expenditures.

Senator CURTIS. Well, I appreciate what you have said. What category constitutes our largest expenditure in our budget now? It is not the military, is it?

Mr. GREENSPAN. No; in fact, the basic group which I singled out in my prepared testimony is the generalized category which we call payments for individuals, which has had an extraordinary growth over the past quarter century.

In fact, excepting the very last 1 or 2 years which are special circumstances, they have maintained a rate of growth approximately

double the rate of growth of the GNP, which means in effect that unless that growth rate is dramatically reduced, it will just overwhelm the aggregate size of the budget.

Senator CURTIS. And a whole series of those benefits may all be paid in one place, is that not correct?

Mr. GREENSPAN. They may well be.

Senator CURTIS. In addition to the financial burden upon the Federal Government, unless there is restraint along this line rather than creating jobs for individuals where they can earn, we add to dependency on the country on the part of some citizens rather than self-reliance and independence, is that not correct?

Mr. GREENSPAN. Yes, sir.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Roth.

Senator ROTH. Dr. Greenspan, last week, Secretary Blumenthal testified before this committee and said the Roth-Kemp bill would be inflationary, and for that reason he opposed it.

Do you believe the Roth-Kemp would be inflationary?

Mr. GREENSPAN. In the broadest sense in which inflation is a problem in this country, the answer is, "No." The reason I say that is while it is certainly true that the bill as now constituted would increase the deficit and Federal borrowing requirements more than H.R. 13511, and as a consequence put more pressure on the money markets and in the short run increase somewhat inflationary pressures, the key, the key to our bringing inflation under control in this country is not related to the short term.

In fact, I think there is probably very little we can do to significantly alter the pattern of inflation which is currently built in over the next 1 or 1½ years.

We must address ourselves to fiscal 1981 and beyond because it is only in that time frame in which Federal policy and Federal programs and fiscal policy generally can effectively bring inflation under control.

It is not in my view a short-term budgetary question, but a longer term one. I do not deny there are risks involved in increasing the deficit in the short term, and I wish there were ways in which we could have significantly avoided that.

We have unfortunately arrived at a point in time where we no longer have the luxury to take a fiscal policy which looks at the short run only. We have now got to risk—and there are risks involved—in endeavoring to make a major break in the underlying growth of the Federal outlays, because if we do not, all of our fiscal fine-tuning to somehow constrain inflation may have some very short-term positive effects, but they will be short term indeed, and the longer term consequences, I think, would threaten the stability of this society.

Senator ROTH. Secretary Blumenthal also said in answer to some of my questions that tax cuts undoubtedly will be necessary in future years in order to offset the tax increases caused by inflation and for other purposes.

Do you agree with me that it makes sense to make these cuts now rather than on a year-to-year basis? Will that have a beneficial effect on the economy?

Mr. GREENSPAN. Not only will it do that, Senator, but I think it will actually lower the deficits which we are looking at.

If you cut taxes on a year-by-year basis, there is no way for that to effectively impact the expenditure process.

As you know, the very substantial part of our outlays are in the so-called uncontrollable areas which mean we need a time frame of at least 18 months to make any significant change.

If you create tax cuts on a year-by-year basis ad hoc, you most certainly will have no effect on the expenditures. So, it is very important to introduce legislation well in advance which specifies what the tax rates will be 3 to 5 years from today, if we are going to have that sort of effect.

I do think if we let things run as they are, we will be faced with another tax cut of significant dimensions effective January 1980, and another one effective January 1981.

I think in retrospect, looking back 3 or 4 years hence, we will find that the tax cuts which effectively will pass by the Congress would not in that instance by significantly different from yours.

Their effect, however, to expenditures could very well be very significant.

Senator ROTH. My time is up. But I would like to ask an additional question or two on the second round.

The CHAIRMAN. Next, we will have Senator Hansen.

Senator HANSEN. I am very much impressed with your testimony, Mr. Greenspan. You say that a reduction in the momentum of expenditure growth can be accomplished by making less revenue available and trusting that there is a political limit to defense spending. Earlier, I know Senator Danforth spoke about a concept that he and Senator Bellmon and Senator Proxmire had offered, which I thought had great merit, and which followed a proposal offered by Senator Curtis.

I do not see too much of a relationship between the inclination of the Congress either to expand or cut back on expenditures and more nearly balance the budget. I believe that the cause of inflation is the ability of the Congress and the Federal Government to make dollars available. If we do not raise the money to meet expenditures, then we authorize deficit spending.

Would you support a constitutional amendment such as Senator Danforth discussed to impose a surtax, to bring to widespread public awareness the fact that if we do not reduce expenditures, we are going to have to increase tax payments?

Mr. GREENSPAN. Senator, I am quite sympathetic to the general notion of that particular proposal. I think it works in the right direction, but I would suspect you would have great difficulty passing the Congress on that.

I would have to look at it in some detail, but in principle, the approach of paying for what we expend, I think, is essential in this country. One of the basic problems we have, obviously, is we create benefits from the expenditure side and what we tend to fail to do too often is to not generate the required revenues for meeting the costs.

I might say parenthetically, I am not in favor of using general revenues for the Social Security System because that is one of the major areas in our Federal budget where when the Congress creates benefits they also impose costs.

That, I think, is the type of restraint generally which we need. I find that approach to creating that sort of restraining highly desirable and in fact it can occur in the same context as reducing taxes generally.

These are not mutually exclusive approaches. I might also say if you asked me 2 years ago, did I think that there was a political limit on deficits and I would say there may be, but it is too large for me to understand what it is.

Whatever it is, it is declining and it is declining rapidly.

I think the American people quite correctly have begun to recognize that deficit spending is the cause of inflation and that inflation is essentially the cause of the malaise that we have seen in this country. So, while I do not particularly like the issue of hoping and trusting that you will be forcing the deficit down irrespective of the level of revenues, at this stage it strikes me as perhaps the least worst procedure to get at what I think is the fundamental problem in this country, the problem which threatens the underlying structure of our system, which is this growth in Federal deficits, which absolutely has to stop, because unless we are willing to repeal the laws of arithmetic, we do not have a chance.

Senator HANSEN. Thank you very much.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, Dr. Greenspan knows how much I respect him as a thinker and cherish him as a friend and he would not then, I think, be surprised if I take severe disagreement with what he has said.

Mr. GREENSPAN. I would certainly hope you would, Senator.

Senator MOYNIHAN. This is as if you had revised your testimony to arouse your old friend here. I think it is a case that I, as much as many and more perhaps than some, have spoken against an unexamined optimism about human behavior as a basis for this. That will get you in trouble and that will not work.

It seems to me, there is just as much to be feared from unexamined pessimism.

What you have said is that democratic processes cannot be trusted to restrain themselves, but McCloy said about the American Constitution, "It is a sail and no anchor." It is a very old strain in Tory thinking and it verges on being antidemocratic. Alan, you know that.

Mr. GREENSPAN. There is one of us who does, Senator.

Senator MOYNIHAN. I will know it for you.

Go back just 15 years in this city and remember one of your predecessors, a distinguished man, surely, and I know you think that, Kermit Gordon. What was Kermit Gordon saying in identifying as the problem of political economy in this country, the issues of fiscal policy?

It was that the Congress could not be trusted to spend money in sufficient amounts and the essential difficulty was fiscal drag. That a progressive income tax brought in more money than Congress would be willing to pump out, and ergo, fiscal drag.

Well, in part, that kind of argument changes the political climate and clearly you have a problem of a Congress being too disposed to spending money today, but surely would not you leave the Constitution alone? Is this not a case of argument? Have you so little confidence in the persuasiveness of your own case that you would bind us to the Constitution, and finally are you prepared to limit the Federal spending so that this equally mindless democracy you describe, having to choose between passing out bread and circuses and arming the legions, chooses bread and circuses, so that the United States looks up one day and finds itself without the military defenses it ought to

have because a fixed constitutional limit gave them the choice between defense and social spending and we chose social spending?

Mr. GREENSPAN. First of all, Senator, I would scarcely describe what I was describing as a mindless democracy going amuck, paraphrasing only slightly.

I was not aware that the constitutional amendment process was antidemocratic. On the contrary, I thought that because of the requirements involved in the Constitution to change it, we need massive majorities of the Congress and of the electorate to make those changes. I think what I am suggesting here is that in its good judgment a democratic system can recognize that there are certain procedures involved which are required to maintain a level of priorities and outlays and procedures which it must impose upon because like all such groupings, all such committees, I think we are all aware that we have to have a series of rules which we all abide by in an endeavor to reach a goal to which we all subscribe.

Now, I think generally we are aware of the process that while everyone is in favor of fiscal restraint, when we get down to individual programs which all of us seem to be more or less desirous of implementing, we find that the sum of the parts exceed the total.

I would suggest that a constitutional amendment or something similar is in fact a highly democratic process by which we are setting rules to engender a certain outcome.

Now, I don't want to say that the type of constitutional amendment I would advocate is a rigid year-by-year budget balance or expenditures limit, but I do think that we have to impose either through that process or some other process a generic mechanism to restrain the level of outlay growth.

I think we impose it on ourselves and I think what we need essentially is a set of rules. We are imposing the rules on ourselves through a highly democratic process.

Senator MOYNIHAN. You are a Tory, sir, and I always thought you were a liberal. Thank you.

Mr. GREENSPAN. I always thought I was a liberal, too, and in fact I still do.

Senator RIBICOFF. Mr. Greenspan, I know that there are many factors that go into the problem of productivity, inflation, increase in exports and the value of the dollar. But, to the extent that we can in this committee in this bill, what should be left out of this bill or what should be added to this bill to help deal with these factors?

Mr. GREENSPAN. Senator, I am very concerned about the issue of productivity in general and I have not addressed myself to this question. I think the basic problem in this country is inflation and that inflation itself has generated an incredibly high degree of uncertainty in the business investment process, and has increased what economists call "risk premiums" and "hurdle rates" of return in the capital investment process and has significantly reduced the incentives to invest in productivity expanding types of equipment.

In my judgment, while unquestionably there are numbers of things that can be done to enhance investment generally and resoluve a number of the problems to which you address yourself, Senator, the main thrust has to be to focus on reducing the underlying inflation rate in this country.

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Second, I should think that anything we can do in the structure of this bill to improve incentives to capital investment would be desirable.

In this regard, I must say I subscribe to the earlier notions that there is no revenue loss net in the caiptal gains tax. This is an unusual tax whose liability is self-initiating in the sense that it is only when you choose to sell an asset that you create the liability and I think we are all very much aware that at higher rates we do depress the liability creation, and in my judgment, it is very difficult to prove statistically—and the data are poor—any cut in capital gains taxes at this point is likely to increase within 2 years aggregate revenue available from that tax.

Senator RIBICOFF. Thank you very much. I know that is a pretty broad question I have asked, but after you think about it more before we mark up this bill, if you could send some other suggestions, and that goes for the other witnesses. I, for one, would appreciate it and I think other members of the committee, as we wrestle with what type of bill to mark up would appreciate it also.

I think we are talking about the key factors of the American economic society today. To the extent that this committee can be constructive, I think we would like to be. It is very important that we address ourselves to these questions.

Thank you very much.

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

Dr. Greenspan, it seems to me that the Roth-Kemp tax cut certainly would encourage consumer demand, increase the deficit substantially and increase interest rates. Rather than fan consumer demand, what we ought to be trying to do is modernize capacity and make our supply sources more even. That ought to be our emphasis, to make us more competitive in the world.

We are putting back into manufacturing capacity the lowest percentage of GNP of any western nation in the world, and the English are next to us. My concern is, and almost all of the economists who testified before us on the Joint Economic Committee have felt that the Roth-Kemp bill goes too far too fast. I share that concern.

Why do you not think that would be the result? It seems to me that we are rewarding the public before we have done our job of discipline here in cutting costs.

Mr. GREENSPAN. First, Senator, I would suspect that if we were to go the way of single year tax cuts, which is essentially the direction we have been going in recent years, I venture a forecast based on the way I think the economy is evolving that the aggregate amount of tax cut that would be engendered as a consequence of successful tax cuts effective January, 1980 and January, 1981, that the total tax cut loss, or, say, tax cut in general, would probably come out fairly close to Roth-Kemp.

I do not think the issue at this stage is whether or not the Roth-Kemp proposal is too large. What it is doing is it is offsetting a significant part of the overall increase in revenues that we get as a consequence of inflation, Social Security tax increases, and from progressive rates generally.

Senator BENTSEN. Well, Doctor, I always read everything that I see of yours with a great interest. I seem to remember early on that you issued a statement in opposition to Roth-Kemp, is that correct?

Mr. GREENSPAN. It was not in opposition to Roth-Kemp. Earlier this year, I was concerned that we would have a tax cut which was heavily concentrated in the lower and middle income groups that would create exactly the type of problem which you mentioned in your opening remarks, Senator, and I would very much prefer to have no tax bill than to have a tax bill whose essential thrust was only to create increased consumption expenditures.

As I said when I testified before the subcommittee of this committee several weeks ago with respect to Roth-Kemp, I think the bill is in the right direction, but I would have preferred more emphasis on corporate tax cuts and cuts in the upper and middle income brackets largely on the grounds that it would enhance capital investment more and would skew the tax cut incentives more to those types of investments which would increase growth and increase everybody's income.

If I had to start from scratch, I would prefer somewhat of a different mix than Roth-Kemp. But considering the bills that now are in place or being appraised by this committee, that is by far the closest to what I think we should be doing.

Senator BENTSEN. Doctor, let me touch on another point here. I believe the bill that came over from the House went a long way in giving an across-the-board tax cut which I prefer. But in addition, it couples it with a cut in capital gains and gives you a corporate tax cut which I think will encourage some of this investment back and modernization of manufacturing capacity. But in addition, I think it has helped to push up the price of stocks in the market.

It means that companies will be able to go out for equity once again. Earning multiples have been so low they have gone to debt equity and these ratios are ratios which are not healthy in this country now, that is, equity to debt.

I would think that that type of a mix would be most appropriate.

Mr. GREENSPAN. I do not think there is any question at this stage. As I indicated earlier, I think we are dealing with a problem of investment malaise in the country which has created an extraordinary state in our economy, and the only way to get us out of it is to create a situation in which we have much less risk in the long term investment and have the types of incentives which inspire people who want to take risks and be willing to invest in the long term future of this country.

At this stage, we have had a dramatic pulling in of long term commitments and it is these long term commitments which have been the major factors historically in creating the extraordinary growth and productivity in this country and made this the most important economy in the world.

At this point the major thing we can do is of course to bring down the rate of inflation over the longer term, but in the short range, to the extent that we can cut the taxes on capital, we can increase the levels of investment even with these inflationary risks involved, and in so doing I would suspect create an across-the-board increase in after-tax real incomes for the American people that would not be able to be achieved by increasing after-tax returns by cutting taxes across the board of in any specific amount.

I think it is very important, where there is a balancing of where the emphasis should be, to lean towards the direction of reducing taxes on caiptal as a way to enhance the income of everybody.

Senator BENTSEN. Thank you.

Senator MOYNIHAN. Some of the other Senators indicated they wish to ask supplementary questions. Senator Danforth?

Senator DANORTH. Mr. Greenspan, the House bill has a corporate rate of 46 percent. The President asked for a phase-down of the corporate rate to 44 percent. I am told without any consideration of reflows at all, a reduction in the corporate rate by one percentage point is less than a $2 billion revenue loss. Now, that is without any reflows considered.

Now, you testified when you were here last month that you would prefer a corporate rate of 40 percent, and last December you wrote a guest column in the New York Times in which you talked about business confidence, the rate of return and there proposed a reduction of the corporate rate to 40 percent.

Now, wouldn't it be possible on a phase basis over a period of 5 years to move the corporate rate down to, say, 42 percent and wouldn't that produce a very small revenue loss and wouldn't it be a substantial boon to business confidence and to investment and to an increase in productivity? And wouldn't the fact that it is a certain reduction, even though it is phased down to that, the maximum effect of it is not experienced until 5 years hence, that the anticipation of that would immediately be realized in the economy?

Mr. GREENSPAN. Yes, I would subscribe to everything you are saying, Senator, and I would like to emphasize that the reason why the phasing is not the problem with respect to getting the benefits is that the major impact of a cut in the corporate rate is that it increases the after-tax rate of return on potential new projects.

Any project which would be initiated today is unlikely to be creating any taxable revenue for 2 years and so if you are evaluating the impact of it, you would clearly be focusing on the cash flows in the second, third, fourth, fifth, and sixth years as a key to your investment decision today.

Hence, if the corporate tax rate is cut immediately as far as that project is concerned, it has no particular benefit; but how you get to, say, 40 percent or 42 percent is really not too important, provided—and this is the major issue—that it is legislated in advance.

I would think that the major change is to stipulate what it is that tax policy generally requires now: A focus.

As I think you said earlier, Senator, it is to focus on 5-year tax rate programs. We used to be very concerned about the expenditure side with 1-year appropriations and we finally got the budget committees and the year required budgetary procedure.

Senator DANFORTH. So, that would be a very good answer to Senator Ribicoff's question, that in a tax bill what we could do is to have a long-range phase reduction of the corporate ratae which would not have an immediate inflationary jolt and that would be anticipated and would produce capital investment very quickly.

Mr. GREENSPAN. Yes.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Roth.

Senator ROTH. Dr. Greenspan, in your earlier testimony you pointed out that in moving in a new direction, there are, of course, certain risks involved.

I think to put that in proper perspective, we ought to stop and consider what happens if we move in the direction that the adminis-

tration is proposing. The administration has opposed Roth-Kemp on the basis of inflation, but isn't it true that a tax cut that is essentially income transfer in make-up has more impact on demand and will result in more inflationary pressures, particularly if you put that together with some of the other policies of the current administration?

The fact, for example, that they pushed for an increase in the minimum wage next January despite the fact that Mr. Miller has called that inflationary, the coal strike settlement which was engineered pretty much by the administration, the recent discussions that the administration is not going to object too strongly to other wage settlements—aren't we risking more inflation with these proposals than we would with the Roth-Kemp proposal?

Mr. GREENSPAN. I would certainly say so, Senator. I thing if we continue along the track which we are now proceeding, leaving rhetoric aside, I fear that we will embark upon a major resurgence of inflationary forces and panic into types of actions which will be exceptionally detrimental to the future of our economic establishment, and would not resolve the underlying inflationary problem.

I think unless we come to grips with the notion that we have got to think now in longer term units on the revenue side as well as on the expenditure side, the underlying problems which confront this country are going to be almost impossible to solve.

Senator ROTH. So that the real merit of the Roth-Kemp approach is that it would be a long-term commitment that we are moving in a new direction.

Mr. GREENSPAN. That is the major benefit of that proposal, Senator, as I see it.

Senator ROTH. Thank you, Dr. Greenspan.

Next we will call the panel consisting of Mr. Lewis W. Foy, chairman of the board of Bethlehem Steel Corp.; Mr. Edward Donley, chairman of the board of Air Products and Chemicals, Inc., on behalf of the Manufacturing Chemists Association; Mr. Edwin Spiegel, Jr., chairman of the board of Alton Box Board Co., on behalf of American Paper Institute; and Mr. Louis W. Jenkins, vice president and controller, Cannon Mills, Inc., on behalf of the American Textile Manufacturers Institute.

Will you proceed?

STATEMENTS OF LEWIS W. FOY, CHAIRMAN OF THE BOARD OF BETHLEHEM STEEL CORP., APPEARING ON BEHALF OF THE AMERICAN IRON AND STEEL INSTITUTE; EDWARD DONLEY, CHAIRMAN OF THE BOARD OF AIR PRODUCTS AND CHEMICALS, INC., APPEARING ON BEHALF OF THE MANUFACTURING CHEMISTS ASSOCIATION; EDWIN SPIEGEL, JR., CHAIRMAN OF THE BOARD OF THE ALTON BOX BOARD CO., APPEARING ON BEHALF OF THE AMERICAN PAPER INSTITUTE; AND LOUIS W. JENKINS, VICE PRESIDENT AND CONTROLLER OF CANNON MILLS, INC., APPEARING ON BEHALF OF THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE

Mr. FOY. My name is Lewis W. Foy, chairman of the Bethlehem Steel Corp. As you said, Mr. Chairman, I am appearing today in my capacity as chairman of the American Iron and Steel Institute.

There is little question that there is widespread agreement that the growth of productive investment in the United States has been inadequate. A greater portion of GNP must be devoted to productive investment if we are to provide employment to a growing labor force, meet our national energy goals, provide a cleaner environment, and keep American industry competitive with foreign business.

The plant closings, business retrenchment, and layoffs experienced by the steel industry in 1977 are evidence of inadequate flows of cash from both earnings and new equity financing in past years.

On balance, the House bill is favorable in changing the bias in the tax laws against savings and investment. Both the reduction of the capital gains tax rate and lowering the taxes of middle income taxpayers will assist in providing equity to industry.

Those provisions which reduce corporate tax rates and make permanent and broaden the use of the investment tax credit are measures which will stimulate much needed capital formation.

However, we believe that the required additional capital could be generated for productive investment if some of these measures were expanded.

The normal decrease in the top corporate tax rate from 48 percent to 46 percent is the first such reduction in 13 years. Some further reduction in the rate would aid all industries, including steel, to generate funds internally for capital investment.

The House bill has improved the investment tax credit in several important areas: The current 10 percent rate which was scheduled to revert to 7 percent in 1981 has been made permanent.

The House bill has also taken a step in the right direction by extending the application of the credit to include the rehabilitation of some existing structures. However, this provision is extremely complex, too narrow in scope and, undoubtedly, will lead to many administrative disputes.

Although the steel industry has a relatively high proportion of its total fixed investment in machinery and equipment compared to many other industries, we strongly endorse the concept of extending the application of the credit to all industrial structures for two principal reasons:

First, to recognize the necessity of new industrial buildings to house new investments in industrial modernization or expansion programs, and, second, to remove considerable costly administrative burdens and litigation which have been prevalent over the years.

For the steel industry, the proposal to allow the investment tax credit to be used to offset a greater amount of the tax liability is one of the most significant improvements that could be made in the investment tax credit.

During the past several years many steel companies have embarked on ambitious modernization or expansion programs at a time when profits in our highly cyclical industry rapidly deteriorated. While average industry capital expenditures for 1975–77 were 76 percent above the 1973–74 level, the average net income for the 3 years was 60 percent below the amount realized in 1974.

In conclusion, we strongly urge that the investment incentives already approved by the House be improved upon in order to provide an important step in long-range Federal tax policies to encourage

capital investment and, in turn, reverse the productivity decline experienced in the past few years.

And, Mr. Chairman, in the case of steel, two additional benefits from capital expenditures are usually realized: first, they are environmentally sound, and, second, they are less energy intensive.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Foy. Next we will hear from Mr. Edward Donley, chairman of the board of Air Products & Chemicals.

STATEMENT OF EDWARD DONLEY, CHAIRMAN OF THE BOARD OF AIR PRODUCTS & CHEMICALS, INC., ON BEHALF OF THE MANUFACTURING CHEMISTS ASSOCIATION

Mr. DONLEY. Mr. Chairman and members of the committee, my name is Edward Donley. I am chairman of the board of Air Products & Chemicals, Inc., and also chairman of the board of the Manufacturing Chemists Association, on whose behalf I am testifying today.

Our association is composed of 189 U.S. companies, which produce a little more than 90 percent of the chemicals manufactured in the United States. The aggregate sales of these companies is $125 billion. We employ 1,200,000 people. Our products are sold mostly to other industrial companies who employ approximately 10 times this number of people—that is, 12 million jobs—in further processing the materials which they purchase from us. Our industry has a $6 billion annual favorable balance of payments.

We believe, in our association, that an increase in the rate of capital investment is of vital importance to the economy. The capital facilities in the American chemical industry were designed for maximum efficiency in an era of low energy cost.

It is important for the U.S. chemical industry to remain competitive in world markets in order to preserve our $6 billion favorable balance of payments. To achieve this, large parts of the American chemical industry capital facilities must be replaced with facilities designed for maximum competitive performance in this high energy cost era.

A substantial reduction in tax rate would foster accumulation of the capital required by the U.S. chemical industry.

The corporate rate reduction provided in the House bill is a constructive step in the right direction, but in our judgment is too small to create the incentive needed to provide the massive capital accumulation which our country requires.

A greater reduction in the corporate profit tax rate will cause an immediate infusion of capital into the hands of business. These are the people who are in a position to make prompt decisions about new capital investments which in turn will create new jobs.

We support the investment tax credit provisions of the House bill. We also believe that the investment tax credit should be extended to cover new industrial structures and also the full credit should be available for those pollution control investments which are financed by industrial revenue bonds.

As a further source of capital, we believe that the tax depreciation rules should be liberalized because accelerated depreciation is an effective means of accumulating capital which is critically needed to replace obsolete plants in this inflationary economy.

The present high rate of capital gains taxation deters investment by individuals.

Lower tax capital gain rates encourage the creation of new innovative companies. They are a source of new jobs and new applications of technology. We, therefore, support reduction of the capital gain rate but not at the expense of reduction in other capital formation incentives.

We are very pleased that the legislation under consideration does not encroach upon the present principles applicable to foreign operations of the chemical industry. The proposals to terminate DISC and to tax currently the undistributed earnings of foreign subsidiaries would be particularly ill advised at a time when this Nation is undergoing a severe crisis in international trade and the stability of the dollar.

Thank you, Mr. Chairman.

The CHAIRMAN. Next we will hear from Mr. Edwin Spiegel, Jr., on behalf of the American Paper Institute.

STATEMENT OF EDWIN J. SPIEGEL, JR., CHAIRMAN OF THE BOARD OF THE ALTON BOX BOARD CO., ON BEHALF OF THE AMERICAN PAPER INSTITUTE

Mr. SPIEGEL. My name is Edwin J. Spiegel, Jr. I am chairman of the American Paper Institute, and chairman and chief executive officer of the Alton Box Board, Co., headquarters in Alton, Ill.

I am appearing here today representing the American Paper Institute and the National Forest Products Association. With me is Norma Pace, senior vice president and economist of the American Paper Institute.

I would like to begin by noting that there is at long last general agreement that the U.S. economy needs to stimulate business investment. H.R. 13511 recognizes this need, and Treasury Secretary Blumenthal confirmed this in his testimony before your committee last Thursday.

Although both the House bill and the administration's most recent proposals provide some tax incentives for business investment, they are not large enough. The proposed tax cuts are scarcely more than the scheduled payroll tax increases that are scheduled to take effect in 1979 and will fall short of the higher taxes all of us will have to pay because of inflation.

API proposes that a larger tax cut be enacted and that it be phased in over a period of years to minimize its impact on Federal deficits. Such a program would restore business and consumer confidence, reduce inflationary pressures in the system, and encourage balanced growth.

Our specific suggestions for committee actions to increase economic activity and reduce unemployment and inflation are spelled out in more detail in our written statement, which we request be included for the record.

I believe that a phased-in program of sizable tax cuts is the prescription for our current malady. New tax cut programs amounting to $80 to $90 billion over a 4-year period could be instituted that would not only encourage savings, private investment, and spending, but

would also reduce inflationary pressures in the United States while minimizing the impact on the budget deficit and curbing the growing presence of Government.

Let me use the paper industry as an example of inflationary pressures in industry. Practically all segments of the paper industry are operating above 95 percent of capacity without output of some important grades, such as paper used in magazine publishing, already straining capacity.

Still the incentives for new capital formation in the paper industry remain weak. Our annual survey of capacity which was just completed shows a relatively small response to this growing supply/demand pressure. Clearly, something is wrong with investment incentives when high operating rates in an industry do not result in major expansion programs.

The survey shows that industry's overall capacity will grow 2.4 percent a year between 1978 and 1981, a figure that is short of the growth needed to support the paper requirements of a full employment economy.

Inflation, coupled with high pollution abatement expenditures, have significantly increased the costs of adding machines or building new mills, and returns still do not justify the risks and the high costs. Tax reductions are essential if capital formation in this industry is to accelerate. Congress must balance carefully the benefits of tax reductions directly to individuals with those given indirectly through reduced business taxes.

A phased-in program would give relief to both and would provide the opportunity to make major and significant changes in taxes to encourage more investment. We believe that higher capital investment is the key to improved productivity in our industry.

We think that productivity is the only way the real standard of living of the Nation can grow. For example, the paper industry's wage negotiations in 1977 and 1978 have raised the average worker's wages and fringes in the range of 10 to 11 percent a year.

Without a compensating offset in productivity, inflation and higher taxes will chew up the gains rapidly. Productivity gains in the paper industry averaged only 2.5 percent a year in 1977 and 1978 to date.

Furthermore, if capacity additions are small and limit our production growth to 2.5 percent a year, output per man-hour will show at best a 3-percent-a-year gain, which is far short of the wage increases. The growing divergence between wage increases and productivity in the paper industry points to a severe cost pressure.

Higher capital investment, which increases both output and efficiency, is the only way the industry can help absorb rising costs.

With this analysis as background, I would like to present a brief summary of our specific tax policy recommendations. First, the corporate profits tax should be reduced to 42 percent by 1982.

The surtax exemption should be raised to $200,000 and rates reduced for earnings below $200,000.

We strongly recommend an increase in the investment tax credit to a permanent 12 percent in 1979.

We support an increase in the tax liability limitation from 50 percent to 90 percent, and urge that it be implemented in 1979.

We recommend applicability of the investment tax credit to all industrial buildings.

We urge a system of flexible capital cost recovery allowances, not tied to asset physical or useful lives.

We recommend permitting construction period depreciation.

We recommend that section 313 in H.R. 13511 be modified to allow pollution abatement facilities to be subject to 5-year depreciation rather than amortization, and that the full investment tax credit be permitted for facilities finance by industrial development bonds which qualify for this 5-year depreciation.

API strongly endorses a reduced tax rate for both individual and corporate capital gains. We support the statement which was submitted by the Forest Industries Committee on Timber Valuation and Taxation before the Senate Subcommittee on Taxation and Debt Management July 14, 1978.

We recommend a 20-percent investment tax credit for capital investment in recycling facilities, and an increase to $200,000 in the limitation for used equipment qualifying for the investment tax credit.

And we support the proposed widening of individual tax brackets and rate cuts.

Mr. Chairman, thank you for allowing us to present our views.

The CHAIRMAN. Next we will hear from Mr. Louis Jenkins, vice president and controller of the Cannon Mills, Inc.

STATEMENT OF LOUIS JENKINS, VICE PRESIDENT AND CONTROLLER, CANNON MILLS, INC., ON BEHALF OF THE AMERICAN TEXTILE INSTITUTE

Mr. JENKINS. Thank you, Mr. Chairman.

My name is Louis W. Jenkins, and I am chairman of the Tax Committee of the American Textile Manufacturers Institute, Inc., ATMI.

In the short time allotted to me today, I will talk about the capital needs and costs facing the textile industry and the need for more favorable tax rules to help make funds available for essential capital formation. The security of millions of jobs provided directly or indirectly by the American textile industry are threatened as never before by the substantial gap between our capital expenditure requirements and our supply of capital funds.

We are currently faced with heavy capital commitments as a result of Environmental Protection Agency and Occupational Safety and Health regulations.

For example, the estimated cost to the industry to meet the new OSHA dust control standards is in excess of $2 billion over the next 4 years. The industry faces another $3 billion expense if the OSHA noise standard is enforced. In addition, the industry will need to spend another $528 to $785 million to meet 1984 water pollution control standards. Operating and maintenance requirements will add another $50 to $81 million annually.

On top of these nonproductive capital expenditures mandated by Government regulations come the tremendous capital requirements connected with the conversion to coal of boilers and other combustion and related facilities which must be added or modified to handle coal.

Given the above capital requirements for nonproductive health, safety, and pollution and energy crises expenditures, and the historic low-profit margins of the textile industry, one wonders how these

needs can be met if expenditures for modernization and expansion are not to be neglected.

And, if the industry is unable to invest in modern plant and equipment because its limited supply of capital must be diverted to nonproductive uses, how is it to survive the ever-increasing competition from low-cost, low-wage foreign producers?

It is in this context that we give you our recommendations for changes in the tax laws pertaining to capital formation.

First, ATMI strongly favors, as a matter of first priority, the corporate rate reductions included in H.R. 13511, although more than a 2-percentage-point reduction of the maximum 48-percent rate is needed to help meet capital formation requirements.

Second, to take account of technological changes and inflation, and to bring the capital cost recovery allowance in line with that granted by most other major industrialized nations, the cost recovery period for all productive machinery and equipment should be no more than 5 years with no cutback in allowable investment credits.

Third, rapid writeoff over a 3-year period, with full investment credits, should be allowed for nonproductive EPA- and OSHA-required expenditures and also for the cost incurred in converting energy facilities to the use of coal. In particular, the provisions of S. 3404, introduced by Senator Bentsen, dealing with rapid depreciation for mandatory OSHA health and safety expenditures, should be added as an amendment to H.R. 13511.

Fourth, ATMI urges that a 20-year cost-recovery period be provided for industrial buildings and that the use of the double-declining-balance method, taken away in 1969, be restored for new buildings.

Fifth, ATMI supports at this time the proposal to make the 10 percent investment credit a permanent feature of the tax code. Consideration should be given to increasing the credit generally to 12 percent, with a flat 25 percent investment credit being allowed for investment in business energy property, pollution control facilities and OSHA-required expenditures.

Sixth, ATMI supports the proposal that investment credits be permitted to offset 90 percent of tax liability in any year.

Seventh, ATMI endorses the President's January 1978 proposal to extend the 10 percent investment credit to industrial structures placed in service or rehabilitated after December 31, 1977.

Eighth, ATMI supports enactment of title IV or the House-passed bill, dealing with capital gains and the minimum and maximum tax, with the exception of the proposed repeal of the alternative 25-percent tax on the first $50,000 of capital gains of individuals. ATMI strongly endorses the proposal sponsored by Senator Hansen and a substantial majority of the Senate to reduce the maximum capital gains tax to 25 percent.

And, last, No. 9, although not a part of the pending bill, ATMI generally supports a change in the tax laws to provide shareholders receiving dividends with a partial credit for corporate tax paid with respect to distributed earnings.

The CHAIRMAN. Thank you very much, gentlemen.

Senator Danforth?

Senator DANFORTH. If you ask 100 people what their specific program would be for tax cuts you would get 100 different answers. I want

to tell you what I think and then I want you to tell me where and why I am all wet.

I think that when we address the question of tax cuts, we have to do something more than win the next election for ourselves. I think we have to do more than just search for what can do the best on the stump.

We have to concern ourselves with the economy and the health of the economy and what we can do in this tax bill to improve this very stagnant situation which we have now in our economy.

I am particularly concerned about the problems of capital formation and productivity. I think we have to address those problems in a tax bill, and specifically to address them, I propose the following:

First, to reduce the corporate rate between now and 1983 to 42 percent on a phased basis.

Second, to increase the investment tax credit from 10 to 12 percent and make it partially refundable.

Third, to expand the asset depreciation range from 20 to 40 percent. It is my view if we do these things, we will do more to increase the opportunities of the American people to grow, to develop their own potential, than we could if we just threw money away, and I would like your reactions to these ideas.

Mr. DONLEY. Mr. Chairman, I would respond this way, Senator Danforth. I fully support everything you have said. I would reiterate, if the capital gains tax rate is improved, that will bring forth a flood of dammed up innovation.

Senator DANFORTH. I support that. I think that is a sure winner that will not lead to a revenue loss. That happens to be Senator Hansen's thing rather than my particular thing.

Mr. SPIEGEL. API thoroughly supports these suggestions in this matter. We are greatly concerned about the ability of the paper industry to generate the amount of capital on a proper basis that will be required to provide for the paper needs of the future. We must find a way to attract this kind of capital on a proper basis or so that we can attempt to renew our plants and provide for summer expansion.

Mr. JENKINS. Yes; Senator Danforth, the ATMI Tax Committee has placed as the top priority a corporate tax rate reduction, as its next priority, increasing the investment credit and shortening depreciation lengths, so we are right in line with what you have proposed here.

We would add one thing. One reason the increase in productivity of the textile industry has been slow is that some 60 percent of corporate research and development has to do with meeting the requirements of Government regulations.

Senator DANFORTH. Can I just ask this before the yellow light goes off?

Most people, I think, if you are asking the average guy, how about corporate tax cuts, most people would say, oh, baloney. We want our taxes cut.

From the standpoint of the American people and their opportunities and their future as individuals, as families, what does this kind of a program for corporate rate cuts and investment credit and accelerated depreciation and so on, what does that say to them?

Mr. FOY. It creates jobs, and that is what we are trying to do in this country today.

Mr. JENKINS. This goes directly into cash flow and then back into machinery and equipment and building expenditure.

Mr. FOY. Mr. Chairman, may I say something? I am glad I came this morning, because the comments that I hear from you and your committee are the most encouraging things that I have heard in a long time. Your statements are better than mine, and I am glad that I am here.

Thank you.

The CHAIRMAN. I wish I were as sure I spoke for the majority of the Senate, but I do believe that we are taxing to the point of being counterproductive. The Treasury would make more money with a lesser rate, as I indicated.

Senator Hansen?

Senator HANSEN. Mr. Chairman, I am delighted with the testimony we heard this morning. I rest my case, but I have one question that Senator Curtis wanted me to ask of Mr. Spiegel.

You say in your statement that practically all segments of the paper industry are operating above 95 percent of capacity. Yet plans for capital investment by the paper industry reflect a relatively small response to this increasing supply and demand pressure.

I think this is an important point.

Would you care to comment further as to why more capital investment is not occurring?

Mr. SPIEGEL. Thank you, Senator. I would be delighted to comment about that, because it is a matter of great importance to our industry.

First of all, we operate in highly competitive markets. Our profit margins, unfortunately, during the last several years, have not been up to our expectations. As a matter of fact, up to the expectations of many of our stockholders.

Second, we have been required to devote huge amounts of capital to trying to accommodate and respond to regulatory requirements and, for the most part, these expenditures have been nonproductive.

Therefore, we do need some additional incentives, some new ways we can begin to attract our capital for replacement and expansion within our industry without going to the debt market. Our industry is pretty well borrowed up.

Senator HANSEN. On behalf of Senator Curtis, thank you very much.

Mr. SPIEGEL. Thank you, sir.

Senator DANFORTH. Mr. Chairman?

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. For your benefit, Mr. Chairman, I would like to ask Mr. Spiegel what famous lock and dam system on the Mississippi River is located closest to your place of business and does it need to be replaced?

Mr. SPIEGEL. Well, Senator, as you know, the lock and dam 26, and that is right near where I am located. I would have to defer to the engineers to know whether or not it needs to be replaced, sir, but I know this much—if it fails, it will mildly upset the commerce and trade in the middle part of the United States.

Mr. FOY. Could I be privileged to respond to a point that Senator Moynihan made? He made the point that the Japanese productivity in the steel business was considerably better than the American steel industry. Reports prepared by Government agencies, particularly the

Wage and Price Council, reports that productivity in the Japanese steel industry is always slightly better than the American steel industry, in spite of the fact that the entire Japanese steel indsutry has been created since 1958.

One point I would like to make with respect to my own company, we have the most modern steel plant in the United States, built since 1962, at a cost of $1.5 billion. We know, based on accurate reports, that the productivity of that plant is materially better than most Japanese plants.

I think that this confirms that if you spend money, you can get good productivity.

Thank you.

The CHAIRMAN. Let me just mention one thing to you, gentlemen, and you can react to it however you please.

I have seen nothing in your testimony about something we are going to vote on in this Congress this year or next year, probably this year.

There is a proposed amendment that will be offered to the so-called sunset bill. The sunset bill is supposed to be a bill to terminate needless Government spending, but there is a proposed amendment that will be offered with very considerable support which would say that all tax expenditures would come to an end at some particular date unless reenacted by the Congress.

That would mean that such items as the investment tax credit, accelerated depreciation, capital gains, depletion allowances, foreign tax credit, deferral on taxes on income earned abroad, just to mention a few, would all come to an end unless extended by Congress.

Some of you say that the DISC is not going to be repealed because the majority of the Congress will not vote to do so. But if that sunset amendment becomes law and the President is against a tax provision, it would not take anything but one-third of the Senate or one-third of the House or the Persident's being opposed to it to deny what is in the law now.

I have not heard the business community express any concern about that matter. My impression is that what is being proposed would mean that a mere one-third in either House, plus the President, could impose what amounts to a $180 billion tax increase. I do not think they would do that on those provisions that help the low-income people or the homeowner, but I can see the distinct possibility in this egalitarian world that we live in today that they would say all these things business enjoys should be terminated, or at least subject to reenactment periodically.

I can see the prospect of some of these things that will not pass on these bills becoming law by that process.

Have any of you gentlemen given any thought to that?

Mr. FOY. No; we have not. Could we submit a paper to your committee on that point?

The CHAIRMAN. Yes, sir. I wish you would. I would suspect we will be voting on that sometime soon. It could be within a month. So far, I believe most business groups, such as these fine associations you gentlemen speak for, are completely unaware of what that is, or what that could do to you.

Mr. FOY. Mr. Chairman, the American Iron & Steel Institute will have a paper to you in a few days.

Mr. DONLEY. We will prepare one also.

Mr. JENKINS. And we will, also.

The CHAIRMAN. That looks to me like a sneaky tax increase, and a big one—a $180 billion tax increase they sneak in by the back door. But sometimes, you know, you gentlemen are working so hard trying to improve the front of your building, you do not look at somebody tearing down the wall in the rear.

Mr. FOY. We need your help in this respect.

The CHAIRMAN. Thank you very much.

We are voting right now.

Perhaps, Senator Hansen, you or somebody else could come back and continue this hearing.

We will take a 5-minute recess.

[A brief recess was taken.]

Senator PACKWOOD. Mr. McCollam, Jr., president, Edison Electric Institute.

STATEMENT OF WILLIAM McCOLLAM, Jr., PRESIDENT, EDISON ELECTRIC INSTITUTE

Mr. McCOLLAM. Mr. Chairman, and members of the committee, my name is William McCollam, Jr. I am president of the Edison Electric Institute, which is the national association of all investor-owned electric utilities in this country. Our member companies supply 77 percent of all electricity users in this country. I have with me here at the witness table on my right, Mr. Ray Dasik, tax counsel for the Edison Electric Co. and with the law firm of Regan and Priest here in Washington.

As I am sure you are aware, the electric power industry is responsible for about one-fifth of all U.S. business plant investment and construction expenditures. It accounts for one-third of all new long-term corporate financing and roughly half of all the new-issue common stock marketed by U.S. corporations.

For the period 1978 through 1992, construction expenditures by the U.S. electric power industry, public and private, are estimated at $850 billion while the industry's new money needs will be in the $500 to $600 billion range. These average out to roughly twice current levels—over $50 billion of new electric plant construction and $35 to $40 billion of new electric industry financing annually.

This suggests we are a very capital-intensive industry, the most capital-intensive of any in the country. Although the bills before the committee address tax relief for the whole spectrum of our society, due to the capital-intensive nature of this industry, our overriding concern, obviously, is with those provisions which address the critical need for capital formation, about which there has already been much discussion this morning.

Among the most important provisions of the House bill, H.R. 13511, are those which make the investment tax credit permanent at the 10 percent level for all taxpayers and provides a 90 percent limit on utilization after the period of phasein.

Maintaining the investment tax credit at the 10 percent level on a permanent basis would enhance its effectiveness in stimulating the economy on a noncyclical basis. It would also encourage plant expansion by providing a predictable longterm financing aid. This is particularly essential in making plans for long leadtime plant construction projects which are typical of the electric utility industry.

Similarly, the 90 percent limit on utilization provision would increase the ability of taxpayers to realize the intended benefits more currently. This would maximize the credit's effectiveness in providing capital for needed plant expansion.

The investment tax credit is an effective means of promoting capital investment. The provisions of the bill regarding the investment tax credit are strongly favored by the investor-owned electric utility industry. Their implementation will provide a significant portion of the internally generated cash needed to help finance our continuing construction programs. Indeed, the adoption in 1975 of a 10 percent investment tax credit was a significant factor in helping the electric power industry to hold its subsequent financing requirements to manageable levels.

If the adequacy of future energy supplies is to be assured, both the 10 percent credit and the 90 percent utilization limit should be made permanent so that taxpayers can count on having the full intended benefit of the investment tax credit.

Finally, making the full credit available for certain pollution control facilities which are subject to rapid amortization provides much needed assistance in financing such facilities.

In my prepared statement, I address a couple of technical shortcomings of the House provisions of the bill which I will not go into here, due to the limitations on time, but I ask that my complete statement be made part of the record.

Now, addressing the reduction of the corporate tax rate which is included in the House bill, we also endorse that feature which reduces the corporate tax rate for taxable income in excess of $100,000 from 48 percent. This rate reduction should result in the stimulation and expansion of the economy, which we feel will benefit everyone, a point again made repeatedly this morning, and which I will not dwell upon here.

We also support the concept of reducing the impact of capital gains taxation, thereby increasing the funds in the private sector that are available for productive investment. We feel, however, that additional tax law modifications are needed to accommodate any cut in capital gains taxes.

A meaningful proposal which is not in the House bill but which would aid capital formation is contained in a Senate bill, S. 3430, introduced on August 18 by Senator Nelson, which provides that taxation of dividends reinvested in additional new stock of the dividend-paying corporation would be deferred until the recipient disposes of the stock.

If dividend reinvestment plans are granted favorable tax treatment, this would provide a significant additional stimulus to the raising of capital, and one that could be quite significant for our industry, and we do urge your serious consideration of this measure.

While the bill under consideration today does not contain any proposals with respect to employee stockownership plans, we reiterate or own hearty endorsement of the expanded Employee Stockownership Act of 1978, S. 3241, which is under consideration by your Committee.

As Mr. Reid Thompson, chairman of the Edison Electric Institute, testified on July 19, 1978 before this committee, we in the electric utility industry strongly support provisions for employee stockownership plans as a truly innovative and important achievement in corporate finance.

These plans have benefited employees and employers by their two-pronged thrust, on the one hand promoting widespread ownership by the workers of stock in the corporations for which they work while, at the same time, providing additional means of capital formation.

We respectfully urge that the principles contained in the expanded Stockownership Act of 1978 be incorporated into the House bill, H.R. 13511 and, as a minimum, we would urge that the present ESOP provisions which expire on December 31st of 1980 be made permanent.

Finally, I would like to address one extremely important problem of our industry, and that is now under consideration in the Senate—that is, contributions in aid of construction and the tax problems that our industry has with that particular problem.

We strongly endorse Senate bill 3176 which provides for excluding from gross income contributions in aid of construction to electric and gas utilities and we urge you to include it in your bill.

S. 3176 would amend section 118 of the Internal Revenue Code to specifically confirm the longstanding rule that contributions in aid of construction to electric and gas utilities do not constitute gross income.

Under this bill, the amounts collected as contributions in aid of construction by electric and gas utilities would be treated as contributions to capital in the same manner as they are treated for water and sewage disposal utilities.

This amendment is extremely important in our industry and is made necessary by the Internal Revenue Service's change of its prior treatment of such contributions to its present policy; its prior treatment going back for a period of more than 50 years.

Failure to treat contributions in aid of construction as contributions to capital will result in (1) a serious inequity between water and sewage disposal utilities, and electric and gas utilities, and (2) either higher electric and gas rates or substantial increases in the amounts of contributions required from customers.

Mr. Chairman, this completes my prepared statement. I would now be happy to answer any questions that you might have.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. With respect to the investment credit, my proposal is that we increase it to 12 percent. I take it you disagree with that; and with respect to the corporate tax rate, my proposal would be over 5 years to phase it down to 42 percent. I take it that you are satisfied with the House bill?

Mr. MCCOLLAM. No, Senator Danforth, I would not say that we disagree with you at all. We think that what is proposed in the House bill is a very constructive step in the right direction, but we would certainly not be unfavorably disposed to liberalizing it along the lines of your suggestion.

Senator DANFORTH. The 10-percent investment credit only preserves the status quo. It does not do anything more at all, and a reduction of the corporate rate to 46 percent, I think it is fair to say, that is 2 percent over what President Carter proposed in January, 1 percent less than those who have been advocating a 45-percent corporate tax rate proposed.

And I do not think that 46 percent is going to make up for the increase in payroll taxes that you are going to have to pay. So I would hope if the business community believes in capital formation and pro-

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ductivity and feels that we have an opportunity to do something about it in this bill, I would hope that they would not come parading before us and tell us how delighted they are with the House bill.

My view is, the House bill is not adequate at all.

Mr. McCollam. Senator Danforth, I do not have any basic disagreement. Our concern in the electric utility industry is that we do everything we can to create incentives for capital formation and therefore for our industry, which is an extremely capital-intensive industry. We feel at the top of our priority list would be the treatment you accord the investment tax credit.

I do not disagree with anything you said. We are concerned that the present law, unless something is done, would require that after 1980 the investment tax credit, as far as the electric utility industry is concerned, will go back to 4 percent.

You may recall there is a discrepancy between the investment tax credit that we were able to take and those of other manufacturing industries—for example, the 7 percent. We feel it is extremely important that we preserve the investment tax credit, at least at a 10-percent level, on a permanent basis.

Senator Danforth. You are just fighting to maintain the status quo, but if we are going to have a healthy economy to provide for the American people, we are going to have to do more than maintain the status quo, are we not?

Mr. McCollam. I do not disagree with that.

Senator Danforth. Do you agree with it?

Mr. McCollam. I agree with it.

Senator Danforth. Do you advocate it? Will you fight for it?

Mr. McCollam. Yes, sir, we will.

Senator Danforth. Thank you.

The Chairman. Senator Packwood?

Senator Packwood. No questions.

The Chairman. Thank you very much.

Mr. McCollam. Mr. Chairman, I must say that this is a unique experience for me, to come before a committee that is so understanding of the problems of capital formation in this country. I think this is the critical problem for our country.

Senator Danforth. We are not all here.

The Chairman. Thank you very much.

Mr. McCollam. Thank you, Mr. Chairman.

[The prepared statement of Mr. McCollam follows:]

Statement of the Edison Electric Institute

My name is William McCollam, Jr. I am President of the Edison Electric Institute (EEI). The Edison Electric Institute is the national association of investor-owned electric utilities which represent 99 percent of these utilities in the United States. Its member companies supply 77 percent of all electricity users in this country. I am appearing today on behalf of EEI.

The electric power industry is responsible for about one-fifth of all U.S. business plant investment and construction expenditures. It accounts for one-third of all new long-term corporate financing and roughly half of all the new-issue common stock marketed by U.S. corporations.

For the period 1978 through 1992 construction expenditures by the U.S. electric power industry, public and private, are estimated at $850 billion while the industry's new money needs will be in the $500 to $600 billion range. These average out to roughly twice current levels—over $50 billion of new electric plant construction and $35 to $40 billion of new electric industry financing annually.

This suggests that the electric utilities will continue to be responsible for at least one-third (and possibly up to half) of all business financing during the next decade and one-half, if they are to provide the expanded facilities needed to fuel our nation's economy and provide jobs and consumer products in the years ahead.

Although the bills before the committee address tax relief for the whole spectrum of our society, due to the capital intensive nature of this industry, our overriding concern is with those provisions which address the critical need for capital formation.

INVESTMENT TAX CREDIT

Among the most important provisions of the House bill (H.R. 13511) are those which make the investment tax credit permanent at the 10% level for all taxpayers and provide a 90% limit on utilization after the period of phase-in.

Maintaining the investment tax credit at the 10% level on a permanent basis would enhance its effectiveness in stimulating the economy on a noncyclical basis. It would also encourage plant expansion by providing a predictable long-term financing aid. This is particularly essential in making plans for long lead time plant construction projects which are typical of the electric utility industry.

Similarly, the 90% limit on utilization provision would increase the ability of taxpayers to realize the intended benefits more currently. This would maximize the credit's effectiveness in providing capital for needed plant expansion.

The investment tax credit is an effective means of promoting capital investment. The provisions of the bill regarding the investment tax credit are strongly favored by the investor-owned electric utility industry. Their implementation will provide a significant portion of the internally generated cash needed to help finance our continuing construction programs. Indeed, the adoption in 1975 of a 10% investment tax credit was a significant factor in helping the electric power industry to hold its subsequent financing requirements to manageable levels.

If the adequacy of future energy supplies is to be assured, both the 10% credit and the 90% utilization limit should be made permanent so that taxpayers can count on having the full intended benefit of the investment tax credit.

Finally, making the full credit available for certain pollution control facilities which are subject to rapid amortization provides much needed assistance in financing such facilities.

We wish to call to the Committee's attention two technical short-comings of the House provisions concerning the investment tax credit. We are certain that they are inadvertencies, but if they are not cured, the result for our industry and other regulated industries will be extremely detrimental. Both pertain to section 46(f), credit limitations in case of certain regulated companies. First, under section 311(c) of H.R. 13511, the references in paragraphs (1) and (2) of section 46(f) to property "described in section 50" have been deleted as obsolete. The unfortunate effect is to subject certain investment tax credits generated in 1971 and prior to the limitations of section 46(f)—limitations which have never before been applied to those credits. Certain electric utilities may thereby be held to be in violation of the section 46(f) limitations. Second, paragraph (8) of section 46(f) has not been amended to add the "Revenue Act of 1978" to the Acts that are not to be considered when determining the amount of investment tax credit that may be immediately flowed through if the section 46(f)(3) election was made by a taxpayer pursuant to the Revenue Act of 1971.

REDUCTION OF CORPORATE TAX RATE

We also endorse the House bill provision which reduces the corporate tax rate for taxable income in excess of $100,000 from 48% to 46%. This rate reduction should result in the stimulation and expansion of the economy, which will benefit everyone.

CAPITAL GAINS TAXATION

We also support the concept of reducing the impact of capital gains taxation, thereby increasing the funds in the private sector that are available for productive investment.

Additional tax law modifications are needed to complement any cut in capital gain taxes. A meaningful proposal which is not in the House bill but which would aid capital formation is contained in S. 3430, introduced August 18, by Senator Nelson, which provides that taxation of dividends reinvested in additional new stock of the dividend-paying corporation would be deferred until the recipient disposes of the stock.

If dividend reinvestment plans are granted favorable tax treatment, this would provide a significant additional stimulus to the raising of capital.

We urge your serious consideration of this measure.

This measure would stimulate additional companies to initiate such plans and achieve the goals of (1) expansion of capital facilities, (2) making more electric energy available to meet projected demand, and (3) increasing employment in all sectors of the economy.

Objections have been raised that a dividend reinvestment deferral plan would create so attractive a tax advantage for shareholders that a company could be compelled to purchase its outstanding issues of common stock and immediately reissue "qualified" stock to its shareholders. The bill meets the objection by disqualifying any distribution, absent a showing of a legitimate business purpose, which occurs within twelve months of the purchase of company stock by the company or an affiliate.

Another objection raised is that deferral would tempt shareholders to reinvest their dividends and then immediately turn around and sell their stock at a profit. This objection has been overcome in the bill by assigning a zero cost basis to shares received on dividend reinvestment, and by providing that any stock sold within one year was received pursuant to such a plan, in which case, all proceeds of the sale would be taxed as short-term capital gains.

EMPLOYEE STOCK OWNERSHIP PLANS

While the bill under consideration today does not contain any proposals with respect to employee stock ownership plans, we reiterate our own hearty endorsement of the Expanded Employee Stock Ownership Act of 1978 (S. 3241) which is under consideration by your Committee.

As Mr. W. Reid Thompson, Chairman of the Edison Electric Institute, testified on July 19, 1978, before this Committee, we in the electric utility industry strongly support provisions for employee stock ownership plans as a truly innovative and important achievement in corporate finance. These plans have benefited employees and employers by their two-pronged thrust, on the one hand promoting widespread ownership by workers of stock in the corporations for which they work, while at the same time providing a significant additional means of capital formation.

We respectfully urge that the principles contained in the Expanded Stock Ownership Act of 1978 be incorporated into H.R. 13511. As a minimum, we urge that the present ESOP provisions, which expire on December 31, 1980, be made permanent.

CONTRIBUTIONS IN AID OF CONSTRUCTION

We strongly endorse S. 3176, which provides for excluding from gross income contributions in aid of construction to electric and gas utilities, and urge you to include it in your bill. S. 3176 would amend section 118 of the Internal Revenue Code to specifically confirm the long-standing rule that contributions in aid of construction to electric and gas utilities do not constitute gross income. Under S. 3176, the amounts collected as contributions in aid of construction by electric and gas utilities would be treated as contribution to capital in the same manner as they are treated for water and sewage disposal utilities. This amendment is extremely important and is made necessary by the Internal Revenue Service's change of its prior treatment of such contributions.

Failure to treat contributions in aid of construction as contributions to capital will result in (1) a serious inequity between water and sewage disposal utilities, and electric and gas utilities, and (2) either higher electric and gas rates or substantial increases in the amounts of contributions required from customers.

Thank you for the opportunity to appear before you today. I shall be happy to answer any questions that you may have.

The CHAIRMAN. Next, we will hear from George H. Lawrence, president, American Gas Association.

VOICE. Mr. Lawrence is tied up in traffic on the way over. I request that he be allowed to testify after the next panel.

The CHAIRMAN. Then we will hear from a panel: Mr. David Garfield, on behalf of the Special Committee for U.S. Exports; Mr. Robert McNeill, on behalf of the Emergency Committee for American

Trade; and Mr. Carl A. Nordberg, and the panel has 15 minutes, 5 minutes a piece.

We will hear from Mr. Garfield first.

STATEMENT OF DAVID GARFIELD, ON BEHALF OF THE SPECIAL COMMITTEE FOR U.S. EXPORTS

Mr. GARFIELD. Thank you, Mr. Chairman and members of the committee. Thank you for this opportunity.

I am David Garfield, vice chairman of Ingersoll-Rand Co. and Chairman of the Special Committee for U.S. Exports, a voluntary group of over 1,250 companies and 51 business associations who share the conviction that the incentive provided by the Domestic International Sales Corporation, or DISC, is vital to the increasingly important export sector of our economy.

We have submitted to the Committee substantial written data in support of DISC. However, I would like to make a few comments in addition.

As you know, the United States ran an unprecedented $26.7 billion trade deficit in 1977 and during the first half of this year, the deficit was at an annual rate of $32 billion. This has profound implications for domestic inflation, worldwide economic stability and perhaps most important for American prestige abroad.

Much of the trade deficit is directly attributable to a lackluster performance on the part of U.S. exports.

In light of this problem, Mr. Chairman, we are dismayed that the administration would propose dismantling DISC, the only significant provision of U.S. law providing an export incentive.

We believe that it has been amply demonstrated that it takes years for incentive programs of this type to be understood and adopted and thus to become effective. Our country has an investment of 7 years in establishing DISC and over 10,000 of them have now been formed. The administration has stated that it supports a positive export program. To eliminate DISC, even if a forceful new program were now established, and that is not the case, would be inadvisable since we cannot afford the years that would be necessary to gain support for the alternate program.

It is also inconceivable that an administration which claims to be concerned about the competitiveness of U.S. exports and is currently engaged in multilateral trade negotiations would seek to emasculate the one specific program Congress enacted to insure our export competitiveness.

Notwithstanding Secretary Blumenthal's statements, there is substantial evidence that DISC has caused real and dramatic increases in U.S. exports since 1971. Specific numbers are contained in our written statement on page 23. In fact, the most recent Treasury report, although negative, concedes that, depending on what kind of assumptions you want to make, U.S. exports were as much as $9.9 billion greater in 1976 because of DISC.

Against this background, it should be clear why the two proposals offered by Secretary Blumenthal last week are both ill-advised and inappropriate. The administration would: 1, Eliminate the special

50–50 profit allocation rule; and 2, place a ceiling on the level of DISC deferral.

We assume the objective is to make DISC meaningless for our larger firms. We think this shows little understanding of the structure of manufacturing. For example, thousands of smaller firms in the aircraft industry have limited opportunity to export their products directly, but do export them as components of the airlines produced by the large firms.

However, Secretary Blumenthal's suggestions, if implemented, would also impact severely on smaller and new-to-market companies. Exporting is inherently riskier and more costly than domestic sales. An effort to squeeze out profitability is thus self-defeating to any export incentive program.

With respect to a ceiling on DISC deferrals, I want to emphasize that this change will not increase benefits to small exporters. Rather, a top limitation would prevent those companies most able to immediately increase our exports from doing so and in many cases would tip the balance toward production offshore, rather than in the United States.

In summary, the administration's suggestions are going in the wrong direction. In light of our Nation's severe trade reverses, what is needed are greater incentives and export assistance. Based on our belief that DISC is an effective export tool, we have recommended two proposals to expand DISC by eliminating the current requirement regarding the deemed distribution and by raising the small business exemption to the incremental rule from the current $100,000 to $500,000.

Thank you.

Senator PACKWOOD. I have no questions. Let me thank you. I have had a chance to peruse your statement and I support your position, but it is the kind of a statement that has a tremendous wealth of facts in it that are very helpful, at least to me, in preparing arguments in this committee and on the floor to continue the defense of DISC.

Thank you.

Mr. MCNEILL?

STATEMENT OF ROBERT L. McNEILL, ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. MCNEILL. I am pleased to be here with you today on behalf of ECAT to give our opposition to President Carter's recommendation for the removal of foreign restrictions.

We are firmly opposed to President Carter's recommendation to eliminate the so-called foreign tax deferral provisions. The consequence of such action would be most harmful to the profitability of U.S. overseas businesses and, therefore, to their competitiveness vis-a-vis foreign-owned firms. The result would be a worsening of the U.S. balances of trade and payments. Both U.S. Government and private studies clearly demonstrate that the operations of U.S. multinational firms produce net balance-of-trade surpluses of several billion dollars each year. U.S. overseas investments stimulate U.S. export sales and contribute many billions of additional dollars to the U.S. balance of payments through the repatriation of profits earned abroad.

In 1977, these repatriated profits are estimated by the Department of Commerce to have totaled $16.5 billion. The Commerce Department also estimated that for 1977 there was an outflow of $5 billion for direct investment abroad, leaving a net surplus on private direct investment account of $11.5 billion to the U.S. balance of payments. Without these profit remittances and balances of trade surpluses, the U.S. balance of payments would be in even worse shape than it is.

Secretary of State Cyrus Vance noted in a February 27, 1978, speech to the National Governors Association that $1 of every $3 of U.S. corporate profits is derived from international activities. To lose all or part of these revenues would hurt the domestic operations of U.S. firms. Total revenues would be smaller as would profits and funds for new U.S. investment. Employment would suffer as would the U.S. economy.

It is useful to outline what is at issue. U.S. exports in 1977 were $120 billion. Official studies and private estimates are that from one-fourth to nearly one-half of total U.S. exports are to overseas affiliates of U.S. firms. Accordingly, between $30 billion to $60 billion of 1977 exports from the United States were shipped to these affiliates. And it is these overseas subsidiaries—the best customers for U.S. goods—who would be economically harmed by subjecting their income to current U.S. taxation. Their profits would be taxed at rates higher than those of their competitors who would be paying on a current basis only the tax of the host country.

In general, no country taxes unremitted earnings from operations of foreign affiliates of their corporations. If the United States decided to do so, we can be certain that, in view of current fierce competition for world markets, no country would be likely to follow our lead.

Secretary Vance also noted in his recent speech to the Governors that nearly 10 million American jobs currently depend on U.S. exports. Using the estimates of U.S. exports earlier referred to, there are between 2.5 to 5 million American workers producing exports for the overseas subsidiaries of U.S. firms. If "deferral" were to be eliminated, many of these jobs would be in jeopardy since the major overseas customers of American exports would be economically damaged.

Accelerated taxation of moneys earned abroad also could result in U.S. corporate taxpayers being taxed on profits never received. This would be analogous to requiring individual shareholders of American corporations to pay personal income taxes on that portion of undistributed corporate profits used to retire corporate debt or to invest in plants and equipment.

As a practical matter, "tax deferral" is applicable or meaningful only in those cases where the foreign effective rate of taxation is less than 48 percent U.S. rate. Where the foreign rate is equal to or higher than the U.S. rate, there is no tax payment due the U.S. Treasury. Where the rates are below the U.S. rate, there is, of course, the obligation to pay the United States the difference between the foreign and the U.S. rate.

Business has long contended that the elimination of foreign tax deferral would result in a significant competitive disadvantage to the U.S. overseas subsidiaries because they would have to pay higher effective taxes than their foreign competitiors. Now, a study by Arthur Anderson & Co., documents that this, in fact, would be the case. It also

shows how ending deferral would mean a revenue loss to the U.S. Treasury and a revenue gain by foreign governments.

ECAT and NAM financed this totally independent study. Arthur Anderson & Co., developed and sent a questionnaire to major American companies presumed to have overseas business interests—88 companies completed the questionnaire.

The companies covered in the study are broadly representative of American overseas business operations. They account for approximately 37 percent of total U.S. overseas direct investment.

The study shows that in 1976, the 88 companies surveyed repatriated 46 percent of their overseas profits, which is very close to the historic average for all firms of about 50 percent. If the 54 percent of overseas profits that these firms did not repatriate in 1976 had been subject to the current U.S. tax, the U.S. Government, with no change in distribution policy, would have collected an additional $206 million.

The major finding of the study, however, is that with current U.S. taxation of all overseas profits, there would be a significant change in the distribution policies of American-owned companies. The static assumption of no behavioral change, on which Treasury revenue estimates is based, is thus not credible. The study shows that companies would repatriate a substantially higher percentage of their profits than they have in the past. The reason why has to do with the interaction between foreign withholding taxes and the U.S. foreign tax credit.

Most countries levy, in addition to other taxes—including income taxes—a special tax on profits that leave their borders. This is usually referred to as a withholding tax on profit remittances. These withholding taxes average 25 to 30 percent of the amount being remitted but are held to much lower levels of 5 to 15 percent by virtue of bilateral tax treaties with the United States.

Withholding taxes qualify for the U.S. foreign tax credit just like direct income taxes paid to foreign governments. As a higher percentage of profits is repatriated, and the total amount of taxes therefore paid the host countries rises, so does the total of foreign taxes eligible for the foreign tax credit.

Based on the data supplied by the 88 companies, the Arthur Andersen study found that if their overseas subsidiaries had distributed all of their profits in 1976 instead of the 46 percent they actually did, the added withholding taxes paid to foreign governments would have been $416 million. Because of the particular U.S. foreign tax credit positions of these companies, the U.S. Treasury would have lost $88 million because of the additional foreign tax credits the companies could have claimed. The study further found that if the overseas subsidiaries had distributed 75 percent of their 1976 profits, then the additional withholding taxes paid to foreign governments would have been $291 million and the U.S. Treasury would have lost $6 million, again because of the build-up of additional foreign tax credits.

These are not approximate but exact figures. The data supplied to Arthur Andersen by the participating companies was the same provided the U.S. Internal Revenue Service for tax purposes. Financial information was provided for each overseas subsidiary. This data was then computed against the actual foreign tax rates in each of the countries where the American subsidiaries are located so that the results are factual, not assumed.

Taking into account the financial position of each of the 88 companies could have minimized their total tax payments by repatriating between 75 percent and 80 percent of their overseas profits. This would have resulted in additional foreign tax payments of $294 million and a U.S. Treasury revenue loss of $88 million, for an overall net tax increase of $206 million to the companies.

Senator PACKWOOD. I must vote, but I am curious about one thing. Are there some countries that do not even tax the foreign profits?

Mr. MCNEILL. Yes, France and Belgium do not tax foreign profits at all.

Senator PACKWOOD. Even when we made it.

Mr. MCNEILL. Even when we made it.

Senator PACKWOOD. I must stop here. I have 4 minutes left to make a vote. The chairman will be back in just a moment.

[A brief recess was taken.]

The CHAIRMAN. The committee will be in order.

Mr. MCNEILL. I am almost finished. I am on page 6 of the text, but I am finished.

The CHAIRMAN. Mr. Nordberg?

STATEMENT OF CARL A. NORDBERG, JR., ESQ.

Mr. NORDBERG. Thank you, Mr. Chairman. I am a partner in the Washington law firm of Groom & Nordberg. I am not appearing today on behalf of any client, but rather, as an interested tax practitioner.

My primary purpose in testifying today is to suggest to the Committee on Finance that it consider whether the time has come for it to become involved in the tax treaty process. It is my personal view that if a role in the treaty ratification process is not accorded the Committee on Finance we are going to see a repetition of the problems which have occurred with respect to the ratification of the U.S.-U.K. treaty. If we continue to experience these kinds of problems with future tax treaties, the whole process will ultimately collapse. If the treaty program deteriorates much further, the foreign commerce of the United States will be the loser.

In the past, tax treaties have been treated like illegitimate children by the Congress and the executive branch. They are too important to be treated in such a manner. Even the garden variety tax treaties that deal with the issues which have historically fallen within their purview, such as the reduction of withholding tax rates and providing limited tax exemptions have significant economic consequences. But the tax treaties of today are different. They involve issues not only of major consequences but they also involve substantive tax policy positions that are sometimes contrary to the policy reflected in the Internal Revenue Code or they encompass new policies that have not been approved for inclusion in the Code.

Consider the recent history of the United States-United Kingdom treaty. If ever there was a tax treaty which deserved to be accorded timely consideration, it was the proposed treaty with the United Kingdom. This treaty is with a major trading partner which has close economic ties to the United States. The United Kingdom treaty is intended to modernize the relationship between the two countries with

respect to income taxes and, in particular, to take into account changes in the British income tax system.

The United Kingdom treaty was sent to the Senate in June of 1976 and it was not reported out by the Senate Committee on Foreign Relations until March 8, 1978. There are provisions in that treaty with effective dates as far back as 1973. The treaty, as proposed, contains several provisions not found in other U.S. tax treaties.

Of particular significance are the new provisions contained in the proposed treaty. One provides for a refund by the United Kingdom to the U.S. portfolio and direct shareholders receiving dividends from British corporations of advance corporation tax paid by the distributing corporation and allows a U.S. foreign tax credit for the one-half of the Act which is not refunded to U.S. direct corporate investors. A second limits the right of states to apportion income of British multinational corporations under the unitary method. A third treats the British petroleum revenue as a creditable tax for U.S. foreign tax credit purposes.

While this important treaty was pending before the Committee on Foreign Relations, two of the provisions listed above became rather controversial.

When the treaty finally reached the Senate floor, a reservation was approved with respect to the provision limiting the states' rights to use the uitary system. Also, it has been reported that an agreement was reached that a protocol will be negotiated whereby the credibility of Britain's petroleum revenue tax would be limited on a per-country basis.

Consequently, the treaty is still not ratified and probably will not be for at least another year.

With respect to the changing use and nature of treaties, I would like to point out that the member of the Committee on Foreign Relations with the greatest interest in tax treaties has suggested that the Committee on Foreign Relations and the treaty process is the appropriate place and way to resolve the very difficult issues which exist today with respect to the foreign tax credit.

Moreover, the Treasury Department's proposal for the elimination of deferral—originally part of the tax reform and reduction bill—contained a provision which would have granted the Treasury Department the authority to continue deferral on a country-by-country basis through the tax treaty process. It should also be noted that if the agreed protocol to the United Kingdom Treatv, which limits creditability of the petroleum revenue tax, the so-called Kennedy protocol, is finallv approved, the treaty process will, for the first time to my knowledge, be used to increase the taxes of a U.S. citizen.

My plea is quite simple. The tax treaty program is an important aspect of our international commerce and will undoubtedly become more important in the next few years. Under existing plans, the new tax treaties are going to include concepts of major and important tax policy. The advisability of including these concepts in our U.S. tax law by means of treaties should not be concluded without consideration and review by at least one of the congressional committees charged with the responsibility of our tax law.

I am not suggesting that the responsibility for review of tax treaties be wholly transferred to the Committee on Finance, but, rather that

the Committees on Finance and Foreign Relations share the review responsibility.

Finally, and with reluctance, I would suggest that if this committee does not obtain some jurisdiction over tax treaties, the Treasury Department should be directed to limit the concepts included in treaties to those which have been historically included or those which are inconsequential and noncontroversial. It would have been more preferable if the United Kingdom Treaty had been so limited. At least, by this time, we would have the basic treaty provisions in effect. As it is, the entire treaty remains in a state of limbo.

Thank you very much.

The CHAIRMAN. Thank you, gentlemen.

Again, let me draw your attention to the proposal that I believe will be offered by Mr. Glenn when this sunset bill is up. The sunset bill is supposed to be a bill that would help to reduce taxes.

Now, we expect to have an amendment offered on it by Mr. Glenn or someone else that would say that the DISC and these various other tax provisions that we havel isted—capital gains, accelerated depreciation, foreign tax credit, all the provisions that can be described as tax expenditures—would expire.

I think a majority of the Senate would not favor repeal of DISC, nor would a majority of the House. If they are successful in passing this amendment to the sunset bill, that would make various tax provisions expire in 5 years, without a majority of either House, that would repeal DISC and also it would repeal the provisions related to capital gains and a great deal of other things.

I would hope that you people would look into it. Have you thought about it? Are your people aware that this is a distinct possibility?

Mr. GARFIELD. We started thinking about it when you mentioned it this morning. We started listening to the testimony and we decided right on the spot that we would try to interject our thoughts in that matter, to the extent of our limited capabilities.

Thank you for bringing that out.

The CHAIRMAN. I do not think the Congress is going to vote to repeal DISC, I think there would be a substantial majority in the Senate in favor of keeping it. But all that is needed to repeal it in the event they are able to put that amendment to the sunset provision into law is one-third plus the President.

Do you not think that would be kind of a horrifying experience for business, to think they were supporting a sunset proposition in order to cut Government spending and result in a tax cut and find out that the result is a sneaky tax increase of $180 billion?

Mr. NORDBERG. Senator Long, that proposal has been around for a few years. I think a lot of people have gone to sleep on it. They just feel that something like this, which would repeal so many of the provisions that are essential could never be enacted. But people do take it seriously.

I think that your bringing this to our attention is going to cause us to be more serious about it.

The Chairman. Some people have said that a tax expenditure has the same effect on the budget as an expenditure of money since in effect a tax cut reduces government revenues and increases the deficit just like increased spending does. In other words both a tax cut and increased spending increase the deficit.

Those who argue and contend that after you collect all that you can squeeze out of someone, in effect you are giving him Government money because you are not taxing all his income away from him. I find it difficult to buy that argument, but following that theory that a tax reduction or a phase-in of tax is a tax expenditure that should be regarded like all other expenditures, they then say that you ought to cut down on it, because it will help balance the budget.

Those who argue that and who vote for this sunset amendment can say that they did not vote to repeal DISC. They just voted to study it—and, unfortunately, after the study there were not enough votes to enact it again.

If your people do not watch out, that is how you might lose the DISC, even though I think you have the vote to sustain your position in the Senate.

Thank you very much.

[The prepared statements of the preceding panel follow:]

STATEMENT AND SUMMARY OF DAVID C. GARFIELD, VICE CHAIRMAN, INGERSOLL-RAND CO. ON BEHALF OF THE SPECIAL COMMITTEE FOR U.S. EXPORTS

DISC was intended to stimulate U.S. exports and to partially offset the competitive advantages provided to foreign exporters by their governments. To the extent U.S. exports are greater today than they would have been in the absence of DISC, and there have been no further erosion in the U.S. export base, DISC has been effective.

According to various measures—including a critical analysis of recent Treasury Department reports, independent analysis and company experiences—DISC has stimulated a significant portion of the dramatic increase in U.S. exports since 1971. By 1975, DISC contributed as much as $9.9 million in additional exports. Because of the increased export attributable to DISC, there have been substantial secondary economic gains throughout the U.S. economy, including significant increases in U.S. gross national product and employment. In addition, the rise in exports and economic activity resulting from DISC have generated increases in federal tax revenues which more than offset the initial DISC deferral.

Serious reverses in U.S. trade in recent years call for a strong national export policy. As in the past, DISC plays an important role in stimulating exports and in U.S. trade policy. In light of the need to stimulate more exports and the current status of international proceedings on the question of export promotion practices, the eliminate of DISC at this time is clearly inappropriate.

Much of the controversy over DISC derives from a misunderstanding of what a DISC company is, how DISC works and what its role in national trade policy is.

Recent Treasury Department suggestions for the modifications of DISC would make DISC less effective, would impact most severely on companies which would be the supposed beneficiaries of such changes, would undermine future expansion in U.S. exports and would be counterproductive.

In light of our trade deficiencies and the need for greater emphasis on exports, the Special Committee for U.S. Exports believes Congress should:

(1) Eliminate the current requirement regarding the "deemed distribution" under DISC; and

(2) Raise the small business exemption to the incremental rule from the current $100,000 to $500,000.

INTRODUCTION

The Special Committee for U.S. Exports is a voluntary group of more than 1,250 business firms, whose operations include the export of U.S. products, and who share the conviction that the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code have been instrumental in enabling U.S. businesses to expand their export operations and to cope with the many tax advantages and direct subsidies provided to our foreign competitors by their governments.

Also supporting the objectives of the Special Committee are 51 business associations reprsenting all sectors of American industry, agriculture and com-

merce. A list of member companies and supporting associations is attached to this statement as Appendix A.

The primary objective of the Special Committee for U.S. Exports ("the Special Committee") is to support the retention and improvement of the DISC provisions, and to oppose changes which would render this vital incentive less effective.

I. OVERVIEW ON THE DISC QUESTION

A. The Revenue Act of 1978 (H.R. 13511)

In his January 1978 tax message, President Carter proposed the phase-out of DISC over the next three years. The House of Representatives, and its Committee on Ways and Means, rejected the proposal and neither group included any modification of DISC in their respective versions of the Revenue Act of 1978 (H.R. 13511).

In testimony before the Committee on Finance on August 17, Treasury Secretary Blumenthal again suggested the DISC program should be phased out. Short of elimination, Secretary Blumenthal further suggested two modifications "to focus (DISC) more effectively."

We believe the Committee on Finance and the Senate should join with the House decision to reject adverse modifications to the DISC program. Such modifications, particularly in light of our trade reverses and the current Multilateral Trade Negotiations, would be ill-advised and counterproductive.

These proposals also ignore clear evidence that DISC has been an effective stimulant for U.S. exports since its creation in 1971. Independent economic analysis, discussed below, and company experiences, such as those outlined in Appendix B, provide conclusive evidence of DISC's effectiveness.

The underlying reasons for the creation of DISC at that time—a worsening U.S. trade balance and the proliferation of foreign export incentives—are as applicable today as in 1971. The continuation of an unacceptably high trade deficit and the unprecedented 1977 deficit, argue for the improvement and expansion of DISC not its elimination.

B. Legislative History

DISC grew out of the recommendations of various government agencies and the Secretary of Commerce's National Export Expansion Council, both of which had been considering during the mid to late 1960's what kind of export incentive the U.S. might provide its exporters within the legal restrictions of the General Agreement on Tariffs and Trade (GATT).

According to the legislative history of the Revenue Act of 1971, which contained the original DISC legislation, DISC was created for two basic purposes—one domestic and the other international. First, DISC was intended to be an export incentive to promote the export sales of goods manufactured in the United States, to stimulate the economy, to help improve U.S. balance of trade, and to stimulate U.S. companies to locate new or expanded production facilities in the United States. Second, DISC was intended to provide a partial competitive offset to the massive export subsidies, incentives and advantages enjoyed by foreign companies and to focus international attention on the proliferation of such devices.

C. Statutory provisions: What a DISC is

The 1971 Act provides that the DISC acts as an agent for the buying and selling of goods for export and export sales promotion. The DISC itself can either be an independent company (export management company, sales agent or distributor) or a related subsidiary established solely to sell and promote the products of its parent corporation. The 1971 Act required, however, that the DISC be a separately incorporated entity in order to qualify for special DISC intercompany pricing rules and a partial deferral of certain export income.[1]

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[1] The Administration has rhetorically referred to domestic international sales corporations (DISCs) as "paper corporations." Indeed, in his August 17 testimony, Secretary Blumenthal stated that "special tax benefits apply only to exporters who establish these paper subsidiaries."

While these statements are technically correct, they are rhetorically misleading. Congress expressly required separate corporate entities in order to clearly identify the export income and expenses eligible for DISC treatment, as well as the purposes for which tax-deferred funds were reinvested. In this way, the stringent DISC receipt and assets requirements could be monitored.

It should be further noted, however, that in many instances company DISCs are more than "bookkeeping" entities and have been allocated personnel, assets and operations. While these cases go beyond the statutory requirements of the DISC law, they clearly demonstrate the commitment of industry to export expansion and the value of DISC in achieving this congressional goal.

The incentive benefits which the DISC provision offer U.S. exporters are twofold. First, special rules offer an exporter a simple and objective means for determining intercompany pricing and profit allocation, rather than burdensome compliance with the complicated and uncertain rules of section 482 of the Internal Revenue Code. Second, one-half of DISC income in excess of 67 percent of a 4-year base period is deferred from taxation—but only as long as the deferred tax is reinvested back into export operations. The statute requires that at least 95 percent of both the DISC's income and assets be export-related.

D. How DISC works

Within this statutory framework, DISC acts to stimulate exports in three ways. First, it provides an increased profit/cash flow incentive to U.S. companies to begin or expand export operations, encouraging them to invest more time, effort and capital on exports. In this way, DISC acts as a catalyst to push U.S. companies over the hurdles to exporting of increased risk exposure and diminished cash flow. Second, DISC provides the economic tools for expanding export business—by making available a significant amount of productive capital and increasing cash flow. Third, through a combination of the incentive to increase exports and capital effects noted above, DISC encourages companies to serve international markets by manufacturing in the United States rather than abroad.

The key to the DISC concept is the fact that taxes on qualified export income are deferred—but a gain only as long as the deferred taxes are reinvested in the export business. The value of DISC lies in its building of a capital fund that grows and is continuously reinvested in specified export activities and assets.

Among the most common export-related assets in which DISC-deferred taxes have been reinvested over the first five years of DISC's existence have included:

(1) Export receivables, where the DISC funds are used to extend and finance credit to foreign buyers and to reduce the risk and higher costs of carrying accounts receivable on export shipments (which normally require a longer pay-back period than domestic sales);

(2) Funds for initiating, expanding and improving export marketing and promotion programs; and

(3) Producer's loans, whereby DISC funds are made available to the DISC's parent for investments in new facilities, or the expansion and modernization of existing facilities, for export production and the development of products adopted to export markets.

It is unfortunate that, at this late date, there remains widespread misunderstanding of the way DISC actually works. A number of studies which have attempted to measure DISC's impact on U.S. exports have focused on the question of whether DISC stimulates sufficient reductions in export prices to achieve meaningful export stimulus.[3]

A similar focus of the price reduction question was instrumental in the prima facie ruling of the GATT panel decision on DISC in 1976. All of this indicates a failure to comprehend how DISC's increase of cash flow and working funds from exports generate significant capital effects which act to spur exports, prevent relocation of facilities offshore, and increase productive investment.

It is not necessary for DISC to reduce basic export commodity prices in order to stimulate exports. In this regard, a recent study has noted:

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[3] A much-quoted study published by the Congressional Research Service in 1976 made precisely this price reduction assumption. Although the report notes that "[t]ax burden studies have generally assumed that the tax falls on capital, or partially on capital and partially on prices," it ignored DISC's effect on capital and went on to construct a so-called "best case-worst case" analysis, wherein it attempted to measure how much of the DISC deferral was passed on as lower export prices. The study wrongly concluded that there would be no DISC effect on exports if no price reductions were made—the "worst case". The CRS study at no time analyzes the effect of the deferred-tax capital pool on exports—which is the primary economic effect of the DISC provisions.

In response to the report, the Treasury Department pointed out that the function of DISC is to increase the quantity of exports through a higher rate of return to the manufacturer and to draw attention to the export market. In its re-rebuttal, CRS argued that this profit motive would be short-lived because it would "attract new investment to the export sector and thereby increase the quantity of exports"—precisely the results Congress wished to achieve.

However, the study concludes that the attraction of new investment and increase in exports would lead to a decrease in export prices and would increase the export market "at the expense of the domestic market". In times of full employment, "full" capacity utilization, and trade balance equilibrium, these might be valid points. Of course, none of these conditions exist. Also, these assumptions ignore the need for continued economic growth and the potential impact of export expansion in that regard.

. . . there is reason to believe that prices are no longer the only—or, in some cases, even the most important—determinant of competitiveness. To an increasing extent products having the same basic functional use are differentiated as to characteristics of design and technology, serviceability, quality features, repair and maintenance advantages, and advertising impact and thus are traded internationally. To these factors must be added availability of credit, customer loyalty, sales methods, dependability of supply, promptness of delivery, and a number of other considerations besides price that influence "competitiveness".[8]

To the extent DISC affects these other factors it serves to increase both the quantity and competitiveness of U.S. exports. In any case, DISC does not offer the opportunity for commodity price reduction because of its reinvestment requirements. Moreover, DISC-deferred income is not forgiven of tax liability and, in a number of circumstances, has to be repaid.

II. THE ROLE OF DISC IN U.S. EXPORT POLICY

Thus, it should not be surprising to discover that DISC companies have maintained their profit margins. In fact, statistics in Treasury Department reports show that U.S. exporters have maintained their profit margins under DISC (i.e., they have not cut their prices; rather these profits are being partially tax-deferred to increase the DISC capital pool).

A. *The need for a strong national export policy*

1. *Economic prospects and problems*

The massive 1977 U.S. trade deficit should serve as a clear signal to U.S. policymakers that there are serious problems with U.S. trade. The $26.7 billion imbalance was more than four times greater than in any previous year and represented an increase of more than $21 billion over the 1975 deficit.

An analysis of this unprecedented deficit, and its continuation into 1978, should also serve as a clear signal that there are serious problems with U.S. exports. The growth in the trade deficit cannot be entirely attributed to increases in oil imports. To the contrary, the increases in the deficit can be attributed to a large extent to the inadequate growth of U.S. export trade.

Similarly, the inadequate growth in U.S. exports cannot be attributed solely to the difference in economic growth rates between the U.S. and its trading partners. A recent Commerce Department report noted that the value of world exports increased more than 13 percent during 1977—"making it the second year of strong trade expansion after the 1975 economic slump". However, as Assistant Secretary of Commerce Frank Weil noted in testimony before the House Banking Committee earlier this year, the U.S. share of world exports decreased in 1977 from 13.2 percent to 12.7 percent. Moreover, the Department of Commerce study showed that the U.S. share of exports dropped in more than 60 percent of our trading partners' markets.

Also of concern to U.S. policymakers should be two predictions made by various government officials which underscore the importance and scope of the export problem. First, the 1978 trade deficit will be of a similar magnitude to the record 1977 deficit, and although some improvement has been seen within recent months even the recent monthly figure of $1.6 billion (the lowest in over a year) would still yield annual trade deficits of $20 billion. Second, it could take as many as 10 years before the U.S. can bring its trade account back into balance.

It is imperative, therefore, that the U.S. government give priority to and assume a more active role in stimulating exports. The need for a strong government export policy was demonstrated in another recent staff report of the Department of Commerce, which noted:

It seems clear that neither the natural working of the market, nor private sector promotion aids, have so far been able to do the job alone. While flexible exchange rates, relative inflation rates, and cyclical growth patterns do have a significant impact on export supply and demand, they cannot assure, in and of themselves, an optimum U.S. export level. For a host of reasons—for example, attitudinal constraints (apprehension about exports, indifference), lack of knowledge, financial limitations, regulatory impediments, foreign trade barriers, gov-

[8] Rober R. Nathan Associates, U.S. Foreign Trade and Employment, May 1977, unpublished manuscript (draft) prepared for the International Trade Research Committee, Washington, D.C.

ernmental interventions in the marketplace, etc.—natural market forces do not fully and freely determine international trade levels.

In order for companies to overcome these impediments, they must have outside assistance of some kind or other. Even large experience exporters, while better able to help themselves than smaller, less sophisticated firms, are still not totally self-sufficient.[4]

In recent years, however, U.S. policy for export stimulation has been characterized by incompleteness, inconsistency and restriction. The trend in government export policy, if it can be said that the United States has one, has been toward "benign neglect". Since 1973, traditional export programs have suffered, and since the end of 1975, the U.S. trade balance with them.

The lack of a coherent and consistent export policy provides little incentive to U.S. companies to incur the extra costs and risk of export business. Stop-and-go policies act as a disincentive to U.S. companies, demonstrating that the U.S. government is not really serious about exports or maintaining U.S. export competitiveness in the face of subsidized foreign competition.

This problem was recognized in a unanimous resolution of the National Governors' Conference adopted in September 1977, which concluded that "U.S. trends in both legislation and administration increasingly hinder and inhibit American businesses' ability to compete successfully abroad" and which called for the retention of DISC.[5]

2. Components of an export policy

As part of such an export policy, the following general goals should be incorporated into its development:

(a) The export policy should be designed to increase the willingness of U.S. companies to export. To achieve this general goal, the export policy must seek to accomplish three more specific goals: first, to stimulate increases in the current export base, by encouraging those companies now exporting to export more and to place greater emphasis on exports; second, to broaden the export base, by encouraging those companies not currently exporting to do so; and third, to prevent erosion of the export base, by encouraging U.S. companies to serve international markets through exports to the largest extent possible rather than from facilities abroad.

(b) The export policy should be designed to increase the ability of U.S. companies to export, by providing the financial and marketing tools necessary to export and to overcome the impediments to exporting; and

(c) The export policy should be designed to increase and maintain the competitiveness of U.S. products in world markets, by counteracting in part or whole the myriad export incentives, assistance and subsidies foreign governments provide to their exporters (including indirect development assistance which substantially affects exports) and by encouraging U.S. companies to develop products adapted to and competitive in export markets.

B. Analytical framework on DISC

1. DISC as an export incentive

At present, DISC is the only U.S. export incentive, that is, a program designed to increase the willingness of U.S. firms to export (by emphasizing export marketing and serving international markets from export production in the United States). If the United States is serious in its intent to increase exports, in the first instance by encouraging companies now in exports to expand and maintain their export operations and to encourage more companies to export, then elimination or curtailment of the incentive of DISC is ill-advised.

The need for such an incentive has been widely recognized. According to recent Department of Commerce estimates, there are 20–30,000 companies in the United States who have chosen not to export. Part of the cause for this situation is the lack of emphasis placed upon exports by the U.S. Government. More importantly, many of these companies do not feel they are capable of meeting the increased costs and risks of exporting, particularly if their products are to meet aggressive and often heavily subsidized competition.

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[4] "U.S. Export Promotion Programs: Policy, Rationale, Strategy and Accomplishments," Office of Market Planning, Bureau of International Commerce, U.S. Department of Commerce, August 1977.

[5] Policy Statement on International Business Legislation (F. 16), National Governors' Conference, September 1977.

One commentator has noted that, despite the competitive advantage which recent declines in the value of the dollar have supposedly given U.S. exports, few will begin or expand export operations because of this pervasive concern over subsidized foreign competition.[6] Another commentator has noted that:

> . . . during the 1960's a large number of U.S. firms appear to have dropped out of, or reduced their marketing efforts in, foreign markets because of aggressive foreign competition and uncompetitive dollar prices. Devaluation to a degree corrected this price anomaly. But this is not the same as saying that devaluation automatically produces increases in U.S. sales abroad. Once burned (by expensive bidding, marketing, distribution and related efforts), it is unlikely that many U.S. firms will return to foreign markets without appropriate incentives and assistance.[7]

In the face of fierce international export competition and foreign government practices which enhance the competitiveness of their exports, DISC was intended to provide an incentive to remain in the international market through exports from the United States, rather than offshore production. DISC is well-designed to accomplish this purpose, both because it partly offsets the advantages which foreign governments give to their exporters and because its benefits are keyed to a continuing reinvestment of export revenues in export-related assets. This effect of DISC—preventing erosion of this country's export base—is an important trade policy consideration, wholly apart from DISC's impact on directly increasing U.S. exports.

2. DISC as an export tool

DISC is also the only official program currently available to U.S. companies which directly enhances their ability to export. While a number of other useful and necessary programs (such as Department of Commerce export promotion facilities, the Export-Import Bank, and the agricultural Commodities Credit Corporation) exist, DISC is the only program which provides export assistance directly to exporters in order that they might address the specific impediments to exporting which affect their operations. In this regard, it should again be noted that Congress required that DISC-deferred funds must be reinvested in export assets and activities; the failure to reemploy DISC funds for those purposes or their use for certain proscribed activities result in the loss of DISC deferral.

3. DISC as a partial competitive offset to foreign export incentives

When Congress enacted DISC, it intended, among other reasons, for DISC to partially offset the effect of our trading partners' massive export support practices, to increase the competitiveness of U.S. products competing with subsidized foreign goods in export markets, and to put some pressure on our trading partners to reform the international rules on export subsidies.

The enactment of DISC in 1971 also resulted from the frustration of U.S. attempts to reform the rules on export subsidies, particularly those on tax-related practices, through GATT and the multilateral trade negotiations. These efforts, particularly strong in the late 1960's were totally without success.[8] Indeed, no reform has been achieved since then, although DISC has played an important role in the increasing pressure to produce a new export subsidies code in the current trade negotiations.

Congress concern and frustration were well-founded. With the reduction of tariff barriers to trade over the past two decades, a non-tariff barriers (and export subsidies in particular) have escalated.[9] As a result, these practices have

[6] U.S. News Washington Newsletter, October 7, 1977.

[7] Lawrence A. Fox and S. Stanley Katz, "Dollar Devaluation, Floating Exchange Rates, and U.S. Exports", Business Economics, January 1978.

[8] For a history of the U.S. efforts to reform the GATT export subsidies code, see White Paper: The Increased Importance of DISC as an Element of U.S. Policy in International Trade, prepared by the Special Committee for U.S. Exports, August, 1977.

[9] The escalation of foreign export subsidies has resulted from existing international rules on taxation of exports, which are unfair to the United States in two ways. First, although the rules purport to restrict the use of income tax devices ("direct-tax" benefits), their vagueness and the absence of effective enforcement have led to the proliferation of very substantial direct-tax export subsidy systems in most major trading nations. The United States virtually alone has strictly adhered to these rules and the DISC program was carefully tailored to be "legal" under the GATT code.

Second, the international rules give "carte blanche" to the remission or rebate of "indirect taxes" on export transactions. The increasing reliance of major trading nations on such indirect taxes, and the increasing size of indirect tax rebates in the absence of other taxes, have given rise to massive subsidies which, while "legal" under GATT, have placed the U.S., which relies primarily on direct tax practices, at a considerable disadvantage in export markets.

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assumed a much more prominent role in determining the competitiveness of a country's exports. With respect to the United States, the effects of these practices have been seen in both lost market shares in exports and the penetration of U.S. domestic markets.

In appendix C, the export practices of six of our major trading partners are outlined. In addition, appendix C presents a series of charts which outline the tax and non-tax export subsidies, advantages and incentives provided in 17 nations as compared with the export practices of the United States. It should be obvious from even a cursory review of these materials that our trading partners have gone to great lengths to stimulate their exporting industries. It should also be obvious that U.S. companies start at a severe disadvantage in export competition.

Even though DISC is of great importance to U.S. companies, its benefits are modest in comparison to the myriad support our competitors receive. In a recent White Paper on the role of DISC in U.S. trade policy, the effects of DISC on export pricing and profit were compared with only one aspect of foreign practices—that is, the non-taxation foreign source income and dividends. The results, shown below in Table 1, are dramatic. These foreign tax practices materially increase the ability of foreign companies either to make significant export price reductions or to accrue substantially larger export profits, thus making them more willing to export and more competitive. By comparison, DISC provides no opportunity for commodity price reductions and increases profits by small amounts relative to each export sale.

TABLE I.—*Effect of certain foreign export tax practices*

Increase in aftertax profit on $10,000 sale attributable to export tax incentive:	
Belgium	$300 (28.7 percent).
France	$280 (28 percent).
The Netherlands	$290 (27,9 percent).
Brazil	$200 (14.3 percent).
Spain	$65 (5.1 percent).
Ireland	$1,000 (100 percent).
United States (DISC)	Insignificant.
Export price reductions made possible by tax incentives:	
Belgium	$330.
France	$300.
The Netherlands	$320.
Brazil	$223.
Spain	$90.
Ireland	$1,000.
United States (DISC)	None.

Source: White paper, "The Increased Importance of DISC as an Element of U.S. Policy in International Trade," Special Committee for U.S. Exports, August 1977.

It should be remembered that these foreign "safe-have" practices, while major in themselves, are but one tax-related export practice offered by our trading partners. To them must be added:

(1) Non-taxation of exports generally or specific export commodities in certain cases;

(2) Special deductions, credits and reserves for export-related expenses and industrial development;

(3) Administrative practices which permit special tax treatment; and

(4) Border tax adjustments, including the remission or rebate of indirect taxes.[10]

On top of this list of tax-related export practices are even more varied and extensive non-tax export practices.

Recent events, however, have created a situation where there is real pressure on other governments to negotiate seriously on the issue of tax-related subsidies. One aspect of this pressure directly involves DISC.

[10] For a full discussion of tax-related export subsidies see the testimony of Richard C. Hammer on behalf of the Special Committee for U.S. Exports before the Senate Banking Committee, Subcommittee on International Finance hearings on Foreign Export Promotion Practices, March 9, 1978.

In 1972, the EEC filed a complaint against DISC under the GATT. At the same time, the United States counterclaimed against the tax practices of three representative European countries—France, Belgium and the Netherlands. In November 1976, a special panel, convened under GATT, reached the preliminary decision in all four cases that each practices "in some cases had effects which were not in accordance with . . . obligations under GATT". The Panel found *prima facie* cases of nullification and impairment, but left final determination to further considerations at which time each country could rebut the findings.

Of the four cases, the DISC decision posed the greatest difficulty for the Panel. In the DISC case, involving a deferral rather than an exemption of tax, the Panel reached its conclusion by focusing on the failure to charge interest on the deferred tax and without considering evidence whether DISC results in bill-level pricing, as called for under the GATT code.

As a result, there is a strong likelihood that the United States could prevail on the issue of DISC's "legality" under GATT if it affirmatively defends DISC on further consideration. In addition, it is believed that the United States could obtain further decisions against the export practices of other countries if it chose to pursue this course to reform the GATT rules.

Also as noted in Appendix E, the GATT decision is only a preliminary one at this point and does not bind the United States to modify DISC in any way. Following the Panel decision, the United States called for the four Panel reports to serve as a basis for reviewing the GATT export subsidies rules. However, the entire GATT proceeding has been stalled and further consideration has not taken place (precluding a defense of DISC) because the European countries have rejected the Panel decisions on their practices and have refused to allow any discussion of them.

Nonetheless, pressure has been brought to bear on our trading partners through this proceeding and to eliminate DISC, the center of this pressure, at this time would be to foresake nearly two decades of U.S. reform efforts. It has been through the GATT procedure that the U.S. has been able, after many years of trying, to finally force the tax-related incentive question.[11]

III. ANALYSIS OF DISC AS AN EXPORT INCENTIVE

Since the enactment of DISC, U.S. exports have risen dramatically from $43 billion in 1971 to $121 billion in 1977. Although numerous factors have combined to cause this increase, there is substantial evidence that DISC has played an important part in this rise.

A. Analytical framework

The policy question which must be answered in a review of DISC is "What would the level of U.S. exports have been in the absence of DISC"?—Critics of DISC have stated on numerous occasions that events and causes other than DISC have primarily led to the dramatic increase in U.S. exports since 1971. Their implication is that DISC-induced exports are therefore insignificant.

This argument overstates the importance of these other events and is largely irrelevant. Industry has never claimed that DISC alone has caused the entire increase in U.S. exports over the past seven years. Similarly, industry has not claimed that DISC alone will resolve our growing trade crisis, particularly as DISC is presently constituted.

By the same token, these other causes commonly cited cannot explain all of the increases in exports since 1971. While these causes (including world-wide

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[11] The Administration has suggested that DISC is no longer required to pursue national trade goals. In the Treasury Department's "Description and Analysis" of the President's original 1978 tax proposals, Treasury suggested that the United States could pursue reform in export practices through countervailing duties actions in the United States.

For three reasons, we believe this suggestion is incorrect. First, and most obviously, countervailing duties do not apply beyond the borders of the United States and their imposition on goods imported into the United States would have no effect in third-country markets. While such action could provide temporary relief for import-competitive industries, it would provide no relief for exporting industries. Moreover, to the extent such a one-sided policy abandons export competitiveness, it is likely that import-competitive industries will also be faced with greater foreign competitiveness and lower domestic competitiveness. See Sanford Rose, "The Secret of Japan's Export Prowess", Fortune, January 30, 1978.

Second, due to either difficulties in interpreting or enforcing countervailing duties laws, few U.S. complainants have ever received substantial relief under those laws and only after long delays. Third, our trading partners, in direct contrast to our efforts in the current trade negotiations to bring more discipline to export subsidy practices, have asked the United States to weaken its countervailing duties law.

expansion of trade and inflation, normal increases in exports, two devaluations of the dollar, and special commercial transactions) can explain much of the dramatic increase, a substantial portion of export expansion can be attributed to export promotion programs such as DISC and the Export-Import Bank. Although it is difficult to quantify the individual effects of each cause, it is clear that DISC has had an important stimulating effect; a critical analysis of the most recent Treasury Report, shown below, shows that DISC accounted for as much as 14 percent of the increases in exports to which it is applicable.

The fact that other events ocurred which benefit DISC implementation and utilization should not be treated as detracting from DISC. The fact that the devaluation erased some of the price-related competitive disadvantage of U.S. exports would have meant little had not DISC influenced non-price competitive factors and induced U.S. companies to take advantage of their new found price competitiveness. By the same token, other export promotion programs would have been less effective had not DISC made available the funds and cash flow needed to fully utilize these other programs.

B. The impact of DISC on U.S. exports

1. Analysis of Treasury Department reports

The Administration has claimed that DISC is "inefficient and wasteful", noting that : a 1977 Treasury Department report to Congress estimates the net effect of the DISC program on 1975 U.S. exports to have been between $1 billion and $2.5 billion. Each dollar of additional exports thus cost between $1.20 and $.49 in tax revenue—a very expensive cost-benefit ratio.

On a number of points, however, these statements may be criticized. Prior Treasury Department studies have shown DISC to be quite effective. Two reports, issued in 1975 and 1976, estimated that U.S. exports were as much as $2.2 billion higher in DISC-year 1973 and $5.1 billion in DISC-year 1974 because of DISC. Indeed, the 1977 Treasury Department report estimates that the "initial impact" of DISC in fiscal year 1975 was $7.4 billion. And the most recent Treasury report concedes.

Restated on a calendar year basis, these initial Treasury estimates would show export increases due to DISC of $4.9 billion in 1973, $7.3 billion in 1974, and a minimum of $8.7 billion in 1975.

Breaking with the methodology of previous reports, the most recent two Treasury reports on DISC suggest that two theoretical assumptions "could be made" which may mitigate the initial impact of DISC. These assumptions—which suggest that DISC may have a negative impact on exports and that some DISC exports merely substitute for other U.S. exports—are theoretically and statistically unsound. Indeed, a theoretical analysis of these assumptions would argue for a larger impact of DISC rather than a smaller one.

It is instructive, for example, that, in reaching the $1–2.5 billion figures, Treasury assumes that DISC provides a competitive advantage to DISC exports at the expense of non-DISC exports; however, the Treasury methodology does not recognize a DISC effect for export sectors in which more than 80 percent of the sector's exports are DISC-related. Moreover, the 1977 report, in analyzing the assertion that DISC exports merely substitute for other non-DISC exports, admits:

A more severe limitation of the method is that it presumes that DISC and non-DISC exports substitute for one another in foregin markets, so that non-DISC exports must be sold on the same terms as comparable DISC exports. *The artificiality of these and other assumptions diminishes the reliability of any conclusions drawn from them.* (Emphasis added.)

While it may be difficult to measure the impact of export-related programs, care must be taken to measure the precise effect of such programs. The 1977 Treasury report recognizes this problem in noting:

These estimates of the DISC effect must be viewed with extreme caution. Other statistical methods might produce different estimates. The method used here rests on the fundamental assumption that DISC and non-DISC exports within each of the broad product groups shown separately in Table 3–1 are the same in all basic respects except the presence of a DISC. However, there may be numerous differences between DISC and non-DISC firms in product lines, company size, attention to export markets, and other characteristics, all of which may affect relative export performance.

2. Independent analysis

What must be measured in reviewing DISC is what U.S.—and on a more basic level, individual company—exports would have been in the absence of DISC. Inasmuch as DISC's effects are, in the first instance, incentive (it stimulates companies to put more emphasis on exports and to locate in the United States rather than abroad), and, in the second, capital and cash flow, a proper analysis of DISC would have to rely on (1) a survey of marketing and investment decisions made by exporting companies in response to DISC and (2) an analysis of the capital effects of the DISC-deferred funds.

In 1975, the Special Committee for U.S. Exports asked Dr. Norman B. Ture to prepare an independent analysis on the impact of the DISC-deferred capital fund on the cost of capital in exporting. Dr. Ture's analysis provided the following results:

(1) Total merchandise exports in 1974 were $6.3 billion greater than they would have been in the absence of the DISC provisions.

(2) Throughout the business sector, including export and supplying industries, there were 442,000 more full time equivalent jobs than there would have been in the absence of DISC.

(3) Wages and salaries paid to employees in export production in 1974 were $0.7 billion greater than the amount that would otherwise have been paid. Adding the $3.4 billion of wages and salaries paid to the additional employees in supplying industries, the aggregate amount of employee compensation in excess of the amount which would have been paid in the absence of DISC is about $4.1 billion.

(4) Aggregate capital outlays throughout the business sector are estimated to have been $23.3 billion more than they would have been without DISC. It should be noted that these estimates, taken together with the critical examination of the Treasury Reports, suggest a consistent range of export increases significantly higher than the Administration's.

3. Case histories

The experiences of individual companies who have used DISC further reinforce the arguments that DISC has been an important incentive. In appendix B, excerpts from letters from such companies are reprinted.

A number of common threads run throughout these letters. Companies who had not been exporting previously began to do so because of DISC . . . companies who once did not place emphasis on exporting now do because of DISC . . . companies who had considered moving production facilities overseas maintained them in the United States because of DISC . . . companies who found their export growth stunted because of their inability to make available competitive credit were able to use DISC to do so . . . companies who found themselves chronically short of investment and working capital have been able to use DISC funds to improve their capital structures.

C. The impact of DISC-induced exports on the U.S. economy

1. Secondary effects

The increase in exports due to DISC directly affects a number of facets of the U.S. economy—employment, economic growth, and federal tax revenues. In addition, this increase in export-related activity indirectly impacts on the economy—so-called "secondary effects".

Arguments for DISC repeal aways prominently cite its tax revenue cost. However, these revenue cost numbers are "initial impact" figures which show the cost of DISC as if they had no impact on economic behavior. Actually, the economic feedback effects of DISC are large and cannot be legitimately ignored. By reformulating the initial export effect estimates of the Treasury Department reports on calendar years and using standard government economic analysis, it is possible to estimate these effects. The results, summarized below, are shown in table 2.

In 1974, the increase in GNP attributable to DISC exports was $18.2 billion, with a concomitant increase in export-related employment of over 300,000 jobs ("man-years of employment") and total increased employment due to exports and GNP effects of more than 950,000 jobs. Similarly, this increase in economic activity would yield approximately $4 billion in federal revenues. In 1975, it is estimated that the DISC effect was, at minimum, $21.7 billion in additional GNP, 343,000 export-related jobs and over one million throughout the economy, and almost $5 billion in increased federal revenues.

Thus, DISC does not lose revenue for the Treasury; to the contrary, it is a revenue gainer. This was also the conclusion of a Department of Commerce report published in February of 1976 which stated: "Accordingly, the direct revenue loss by the DISC tax deferrals ($1.3 billion in 1975) is more than offset by the indirect effect of the increased exports of increased GNP revenue gains ($2 to $3 billion indirect revenue gains in 1975)." [11]

TABLE 2

	1973	1974	197
I. Increased exports (billions):			
Total U.S. exports	$70.3	$96.9	$105.6
Increase since DISC	$27.6	$54.2	$62.9
Increase due to DISC	$4.9	$7.3	$8.7
II. Increased GNP (billions)	$12.2	$18.2	$21.7
III. Increased employment (man-years):			
Increased export employment due to DISC	225,400	302,400	343,600
Total increased employment due to DISC exports and GNP effect	669,240	965,100	1,070,300
IV. Increased Federal revenues (billions):			
Increased Federal revenues due to DISC exports and GNP gains	$2.81	$4.19	$4.99
DISC "tax expenditure"	.65	1.13	1.38
Net gain in Federal revenues	2.16	3.06	3.61

Note: Total U.S. exports excludes export shipment of goods to which DISC is not applicable, that is, goods subsidized by other U.S. programs and the reexport of foreign goods.

D. "*Negative*" *feedback effect*

A commonly cited argument for DISC repeal is that DISC-induced exports may actually have an adverse effect on U.S. employment. The argument claims that increases in exports will increase the value of the dollar through the floating exchange rate process; the increase in the dollar value makes imports less expensive, increasing the level of imports; this, in turn decreases employment in the more labor-intensive import-senstive industries.

The simple equation of exports and imports through exchange rates need not have these effects. Even if the floating exchange rate system were working perfectly (which it is not); and the exchange rate adjustment process were immediate (which it is not); and all other things were equal (which particularly as noted in the decision of foreign export subsidies above they are not), the expansion of exports through DISC would still not adversely affect import-related employment. Moreover, if U.S. trade were in surplus and the value of the dollar appreciating rapidly, which of course they are not, it is not clear that exports would have a negative effect on import-competitive employment.

1. To the extent that the U.S. trades exports which require labor for raw materials and oil, this criticism is irrelevant. Forty percent of U.S. imports are comprised of such raw material and fuel imports. These commodities are not labor substituting. To the contrary, to the extent the U.S. produces industrial goods and finished products from them and they are required in or to run industrial processes, they are labor supporting.

2. It is not at all clear that U.S. imports are any more labor-intensive than the manufactured products comprising two-thirds of U.S. exports.

3. The problems facing import-sensitive industries do not result from DISC or any small appreciation in dollar values which might be attributable to it over the the long run. Indeed, many of the problems facing these industries are the same as those facing export companies—a declining competitiveness of U.S. products in world markets, the subsidization of foreign competition, and the need for greater capital formation and development. The proper response to the import problem cannot be creating a greater export problem as well, thus decreasing national income and increasing domestic inflation.

The proper response should be based on addressing the special needs of import competitive industries. First, the need for capital formation has been well documented and we fully support the expansion of domestic capital formation incentives. Second, protection from the unfair competitive practices of foreign companies require more vigilant enforcement of countervailing duties laws.

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[11] Charles S. Friedman, "Estimate of Cost Effectiveness of the DISC Legislation", Office of International Finance and Investment, U.S. Department of Commerce, February 1976.

However, the special problems of exporting must also be recognized, requiring special programs designed specifically for exports, and there should be no trade-off between necessary export expansion programs and other domestic incentives.

E. Analysis of DISC participation

Another frequently heard criticism of DISC is that it favors larger exporting companies which have traditionally been involved in export trade and that small business exporters have derived little benefit from DISC. For example, the Treasury "Description and Analysis of President Carter's Tax Package" states: "According to the 1977 Treasury Report on DISC, over 60 percent of total DISC tax benefits went to parent corporations with more than $250 million in assets."[13]

The most recent Treasury report also notes that 10,144 DISCs had been formed by the end of March 1978. By definition, such a large number of companies necessarily include a significant percentage of small companies. And as the excerpts from letters regarding DISC in Appendix B demonstrate, these smaller companies heavily use and are dependent on DISC. Indeed, some of them have noted that the retention of DISC is vital to their survival in export markets.

It is only natural to expect that companies who had been in exporting prior to the enactment of DISC—which were primarily larger ones—would have been the first to utilize DISC. However, it should be noted that these larger corporations have historically accounted for more than 60 percent of U.S. exports. Thus smaller corporations can be said to make relatively greater use of DISC in proportion to their share of exports than are larger companies.

Moreover, the larger companies are bound by the same reinvestment rules that smaller companies are; the fact that they were exporting before 1971 is, therefore, irrelevant. To the extent that they must use DISC-deferred taxes to increase their exports, and maintain production in the United States, they have acted consistent with DISC's purpose.

The underlying problem of small company use of DISC, by Treasury's own admission, is "the legal and accounting costs of complying with the complex DISC legislation." We do not agree, however, that this complexity of the DISC law negates its economic benefits. Nor should the fact that DISC has some administrative shortcomings obscure the equally clear fact that DISC has been of significant importance to many U.S. exporters.

It simply does not follow from this complexity that DISC tends to benefit large exporters at the expense of smaller ones. The problem is not that large companies are accruing DISC benefits which should be accruing to smaller companies. The questions are whether DISC is sufficiently accessible to all exporting companies and whether it should be expanded to provide greater incentive for exporting.

IV. ANALYSIS OF TREASURY DEPARTMENT PROPOSALS

In his testimony before the Senate Finance Committee on August 17, Treasury Secretary Blumenthal suggested two modifications in the current DISC law which he claimed would make DISC a more effective and equitable incentive. Contrary to the claims, these modifications would make DISC less effective, would penalize the wrong companies for the wrong reasons, and would have a seriously adverse impact on U.S. exports.

A. Elimination of the "50-50 profit allocation rule

1. Current law

The current DISC legislation provides two special DISC inter-company profit allocation methods in addition to the general method provided under Section 482 of the Internal Revenue Code. Section 482 requires that transactions between related companies must reflect "arm's length" pricing, that is, the purchase price must be equal to what the "selling" company would charge an unrelated third party for the same products.

Because compliance with Section 482 is often complicated and burdensome, and because Congress specifically required the establishment of related

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[13] It should be noted that DISC-year 1975, the year analyzed in the 1977 Treasury Report, was something of an anomoly. Since DISC's enactment, the percentage of DISC benefits accruing to larger companies has declined, reaching 52 percent in DISC-year 1974. This trend should continue and accelerate because of the incremental rule adopted in 1976. 1975 was also an exception because of the increased number of companies in the "large" category and the increased shipment of capital goods by these companies. Treasury's statement implies that DISC should be repealed to punish those companies for their growth and their increases in exports.

subsidiary entities in order to qualify for DISC treatment, Congress provided the two special DISC rules. One permits the DISC and its related suppliers to split the combined profit from export sales 50–50. The second permits the related suppliers to "pay" the DISC a four percent commission on gross export receipts. It should be remembered, however, that the DISC does not retain all of the profit and income allocated to it; the DISC mus return a "deemed distribution" of one-half of its income to its parent corporation. In addition, the amount of income the DISC is permitted to retain is also reduced by the 85–40 percent reduction in benefits enacted under the incremental rule adopted in the Tax Reform Act of 1976. Thus, for example, where the 50–50 rule is used, the amount of income permitted DISC deferral is actually at most 25 percent (50 percent of 50 percent) of combined export profits, which are reduced by the incremental rule. The remaining 75 percent of export income (plus the non-incremental income) are currently subject to regular corporate taxes.

2. Treasury proposal

Secretary Blumenthal's testimony suggested that the 50–50 rule be eliminated. The justification given for the suggestion was that "artificial pricing rules . . . permit favorable allocation of export profits to the DISC" and that "many DISC benefits now go to exporters with large profit margins—companies that would obviously be exporting in the absence of any special tax incentive". In addition, the testimony implied that such a restriction would further the goal of simplying the DISC law.

3. Special committee comments

Complexity.—Congress enacted the special DISC pricing rules in 1971 for the purpose of providing simple and objective means of determining the amount of income eligible for deferral under DISC. The complexity of DISC arises from other provisions of the law, expecially those dealing with the incremental rule adopted in 1976 and qualifying definitions. If the Treasury goal is to promote simplicity, Congress should consider eliminating those more complex rules, not the special pricing rules.

Indeed, the Treasury suggestion would be counterproductive in this respect. It would force companies with even normal profit margins to use Section 482 rules and would require Internal Revenue Service scrutiny of every DISC export transaction—precisely the situation Congress sought to avoid in 1971.

Impact.—The impact of the proposed modification would affect most severely those companies which Treasury says it most wants to assist: smaller exporting companies and new-to-market firms. As shown in Table 3, the smallest DISCs have the highest profit margins according to DISC return data contained in Treasury Department reports.

This fact should not be surprising since these companies must expend substantial sums for export marketing and development and must seek to recoup expenses through higher profit margains. With respect to smaller companies in particular, they are also the least able to afford these investments in that they find themselves critically short of working capital, as well as the least able to assume the higher risks of exporting. Thus, it should also not be surpri[illegible]g, as noted in the excerpts contained in Appendix B, that small exporting companies are highly enthusiastic about DISC. On the other hand, these companies are hardly ones which would "obviously" be exporting in the absence of DISC.

TABLE 3.—DISC PROFITABILITY

Size category (gross receipts)	Gross receipts (millions)	Income (millions)	Profit margin (percent)
$1 plus	$6	$1.3	21.6
$50,000 plus	96	17.4	18.1
$250,000 plus	638	73.6	11.5
$1,000,000 plus	6,403	574.4	9.0
$10,000,000 plus	16,131	1,388.1	8.6
$100,000,000 plus	10,421	912.9	8.8
$250,000,000 plus	30,978	1,674.1	5.4
Total for active DISC's	64,673	4,642.8	7.2

Source: "Domestic International Sales Corporations," Robert Feinschreiber, Practicing Law Institute, 1978.

Profit Trends.—Previous Treasury Department reports have noted that export profits have tended to be much higher than domestic profits over the recent past because of the effects of domestic wage and price controls imposed during the early 1970's. As evidenced in the most recent Treasury report, however, the average profit rates on DISC exports have begun to decrease. Indeed, the 1975 DISC "revenue cost", which had been projected to be $1.38 billion, was actually almost a quarter of a billion dollars less ($1.16 billion) primarily because of the diminished DISC profits that year.

Reduced Incentive.—As we noted above, DISC provides an incentive to begin, expand and maintain export operations because it provides a "profit and cash flow" benefit to companies sucessfully engaged in exports. Arbitrary reductions in the amount of these factors necessarily reduce the effectiveness of DISC as an incentive. The Treasury proposal accomplishes precisely that result. Indeed, it makes an already modest DISC even more modest.

As a matter of policy, it should not matter what absolute amount of funds is made available through DISC (provided, of course, it is not unrealistic), so long as those funds are reinvested in the types of export-expanding activities Congress specified.

The Nature of DISC.—It should be remembered that DISC does not subsidize export *per se*, but rather is directed to profitable export operations. DISC benefits can be obtained only if a company is profitable; the 1976 restrictions, making that requirement even more stringent, provide benefits only as long as a company is both profitable and expanding its exports. Since these limitations have already been engrafted on DISC, there is no justification to further limit the value of DISC through profit restrictions. In fact, the Treasury proposal has the effect of penalizing profitable exporting companies and, in a sense, rewards poor management in certain kinds of companies.

B. Limitation on DISC deferral

1. Treasury proposal

The second suggestion offered in Secretary Blumenthal's testimony "would place a dollar limitation on DISC benefits". Although it is not clear whether such a limitation would apply to annual DISC benefits or cumulative benefits, the reason offered for the suggestion is to "target the relief to small companies that may experience difficulties entering the export market".

2. Special committee comments

Export Policy Goals.—The Special Committee agrees with Treasury that more firms, and smaller companies, must be encouraged to export in order to broaden the currnet U.S. export base. To that end, specific proposals have been advanced by Special Committee for U.S. Exports to make DISC more beneficial and accessible to those companies.

However, this proposal would provide no additional incentive for small exporters. Its only effect would be to penalize larger exporters. Moreover, it would do so by reducing other incentive effects which are of equal importance in expanding the current export base (by stimulating companies now exporting to export more) and prevention the erosion of that base (by encouraging companies to maintain U.S. facilities and serve international markets through export production). To the extent the Treasury proposal would limit both the incentive and reinvestment capital available to larger exporting companies to accomplish these latter goals, it would have detrimental effects on U.S. exports.

Amount of Deferral.—It must be remembered that the amount of income permitted deferral under DISC is extremely modest in terms of a company's export sales and the capital and cash flow required to support those sales. On the average DISC sales, the amount of income which can be tax-deferred is about three percent of the sales price and the actual amount of tax-deferral is about 1.5 percent of sales.

Moreover, regardless of what the amount of actual deferral under DISC is, all companies are required to invest those funds in export-expanding activities. It makes little sense to deny those companies most able to make major export investments the tools with which to undertake those projects, particularly where the smaller companies receive no benefit from this proposal (and will be adversely affected by the first proposal). In fact, such an arbitrary limitation on the incentive and investment value of DISC could force major exporting companies to reevaluate their international marketing strategies and shift facilities offshore in order to maintain markets, competitiveness and profitability. In that

respect, the Treasury proposal would be clearly counterproductive in that it would promote the erosion of the U.S. export base.

The membership of the Special Committee recommends that the Administration's proposals to phase out or adversely modify DISC be rejected.

Moreover, in light of our serious trade reverses and as part of an aggressive national export policy, the Committee recommends that the DISC incentive be improved and expanded. Specifically, the Committee recommends the following improvements:

1. Within the context of the incremental rule adopted in 1976, the deemed distribution of 50 percent of DISC income should be eliminated.
2. To provide greater incentive for small exporters, the small DISC exemption to the incremental rule should be increased from the current $100,000 to $500,000 to more nearly reflect the standard government definition of small businesses.

CONCLUSION

In conclusion, the Special Committee for U.S. Exports believes the principal reasons for opposition to DISC from some quarters is a misunderstanding of what a DISC is, how it works and its long-standing role in the U.S. export policy.

We hope the information we have provided in this statement will serve to bring about a more accurate view of the role of the Domestic International Sales Corporation provisions, its cost effectiveness, its job-creating record and potential for the future, and its revenue-producing benefits.

APPENDIX A

Membership of Special Committee for U.S. Exports, August 1978

AC Manufacturing Company
AMCA International Corp.
AMI Industries, Inc.
A-T-O Inc.
A.V.P. Enterprises, Inc.
Abbott Laboratories
Abington, Inc.
Acker Drill Company, Inc.
Acme-Cleveland Corporation
Adamas Carbide Corporation
Addison-Wesley Publishing Company
Africa-Middle East Marketing, Inc.
AgMet Refining Corporation
Ag-Tronic, Inc.
Ahern International, Incorporated
Air Products and Chemicals, Inc.
Airco, Inc.
Airflow Company
Ajax International Corporation
Ajax Magnethermic Corporation
Akzona, Inc.
Alabama Metal Industries Corporation
Aladdin Industries, Inc.
Albany International Corp.
Alco Standard Corporation
Alcon Laboratories, Inc.
Alice Manufacturing Company
Aljet Equipment Company
Alkota Mfg., Inc.
Allegheny Ludlum Industries, Inc.
The Allen Products Company
Allied Chemical Corporation
Allied Products Corporation
Allis-Chalmers Corp.
E. D. Allmendinger Int'l Sales Inc.
Alloy International Company
Alox Corporation
Altama Delta Corporation
J. M. Altieri, Inc.
Alvey Inc.
American Can Company
American Creosote Works, Inc.
American Equipment Company
American Export Lines, Inc.
American Fastener Components, Inc.
American Franchise Systems of Florida Inc.
American Hoist & Derrick Company
American Hospital Supply Corporation
American Livestock Producers International, Inc.
American Lumber International, Inc.
American Medicorp Inc.
American Microsystems, Inc.
American National Rubber
American Olean Tile Company
American Precision Industries Inc.
American Safety Equipment Corporation
American Saw & Mfg. Company
American Telecommunications Corp.
American Uutraviolet Company
Amicon Corporation
Amprestes DISC Overseas, Ltd.
Amstand, Inc.
Amtel, Inc.
Anaconda Company
Analog Devices, Inc.
Anatomy Laboratory Aids, Inc.
Anchor Hocking Corporation
Anderson Greenwood Co.
Ansul Company
Antex, Inc.
Apache Corp.
Applied Data Research, Inc.
Applied Power Inc.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Aqua Manufacturing, Inc.
Archer Daniels Midland Company
Arditi Export Corporation
Arkansas Company, Inc.
Armco Steel Corporation
Aro Corp.
Articor, Inc.
Ashland Oil, Inc.
Aspro, Inc.
Associated Enterprises Int'l., Inc.
Astrosystems, Inc.
Atlantic Chemical Corporation
Atlanta Creosoting Co., Inc.
Atlantic Richfield Company
Augat Inc.
The Austin Company
Autodynamics, Inc.
Automated Building Components, Inc.
Avnet, Inc.
Aydin Corporation
B–Safe Systems, Inc.
Babcock Industries, Inc.
Bacon Industries Inc.
Badar Export and Import Inc.
Bafco, Inc.
Baker International Corporation
The J. E. Baker Company
B. A. Ballou & Co. Inc.
Baltek Corporation
Bandag, Inc.
Band-It Company
Bangor Punta Corporation
The Bank of New York
Barber-Greene Company
C. R. Bard, Inc.
Bard Overseas Corporation
The Barden Corporation
Base Ten Systems, Inc.
Bates Manufacturing Company
Louis P. Batson Company
Bausch & Lomb Incorporated
The Beaton & Corvin Mfg. Co.
Rudolph Beaver, Inc.
Beckman Instruments, Inc.
Becton, Dickinson and Company
Beech Aircraft Corporation
Beker Industries Corp.
Belden Corporation
Bell & Howell Company
Belmont Industries, Inc.
Bender Welding & Machine Co., Inc.
The Bendix Corporation
Bentley Laboratories, Inc.
M. R. Berlin Co., Inc.
Berr.co International, Inc.
Bertea Corporation
Bickley Furnaces Inc.
Big Three Industries, Inc.
Billco Manufacturing, Inc.
BioMarine Industries Inc.
Bird Machine Company, Inc.
J. R. Bisho Company, Inc.
The Black & Decker Mfg. Co.
D. Black & Son, Inc.
Blast Furnace Products Corporation
Blickman Health Industries, Inc.
Bliss & Laughlin Industries, Inc.
Blue Spruce International
Bodger Seeds Export, Ltd.
The Boeing Company
Bogart International Sales
Philip F. Bogatin, Inc.
Bohemia Inc.
Boiler Tube Company of America
Bond Textile Machinery, Inc.
Borden, Inc.
Borg-Warner Corporation
Born Export Corporation
Bowen Tools, Inc.
Braden Industries, Inc.
A. B. Brannock Ltd.
J. B. Braswell Co., Inc.
Briggs & Stratton Corporation
Brooks and Perkins, Inc.
Brown and Sites Co., Inc.
Bruckner Machinery Corp.
Brunswick Corp.
Buckman Laboratories, Inc.
Bucyrus-Erie Company
The Budd Company
Building Products International Corp.
Bunge Corporation
Bunker Ramo Corporation
Burr-Brown Research Corporation
Burrows Equipment Company
Byers Photo Equipment Company
CAFCO International Limited
CEU International Corporation
C & M Corporation
CML Group, Inc.
CR Industries
CRS Design Associates, Inc.
CWT Farms Inc.
Calbiochem
Cam Industries, Inc.
Camerican International, Inc.
Cameron Iron Works, Inc.
Camp Dresser & McKee Inc.
Canberra Industries, Inc.
Carborundum Company
Cardinal Export Corporation
Jams W. Carmichael Export-Import
Carolina Steel Corporation
Carp Industries, Inc.
Carpenter Technology Corporation
Carrier Corporation
Carton-Print, Inc.
J I Case Company
Castaldo Products Manufacturing Corp.
Castle & Cooke, Inc.
Catawba Valley Machinery Co.
Cayuga Machine & Fabricating Co., Inc.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Celanese Corporation
Celeste Industries Corporation
Central Packing International Co.
Central Tool Company, Inc.
Centrexport Inc.
Centronics Data Computer Corp.
Century Merchandising Corporation
Cessna Aircraft Co.
Champion Spark Plug Co.
Charlotte Aircraft International Company
Charter Group International, Inc.
Chase, Tarifero & Morgan, N. V.
Chattanooga Pharmacal Company
Henri Chavez Corp.
Chemcut Corporation
Chemineer, Inc.
Chemplast Inc.
Chesapeake Corporation of Virginia
Chesebrough-Pond's, Inc.
Chew International Corporation
Chicago Bridge & Iron Company
Chicago Pneumatic Tool Co.
Chief Industries, Inc.
Chip-Mate Systems Incorporated
Alf. Christianson Seed Co.
Chromalloy American Corporation
Charles B. Chrystal Co., Inc.
Cincinnati Milacron, Inc.
Cinefot International Corp.
Citrus Machinery Co., Inc.
Claremont Polychemical Corporation
Clark Equipment Company
Classic Chemical International, Inc.
Clow Corporation
Cluett, Peabody and Company, Inc.
Coachmen Industries, Inc.
Cobe Laboratories, Inc.
Codo Manufacturing Corporation
Coherent Radiation
Collins & Aikman Corporation
Colorado International Exports Inc.
Henry Colt Enterprise, Inc.
Colt Industries Inc.
Columbus Instruments Export Corp.
Columbus McKinnon Corp.
Comdisco, Inc.
The Commercial Export Company, Incorporated
Commercial Metals Company
Commercial Shearing, Inc.
Composite Technology, Incorporated
CompuScan Inc.
Computer Concepts Corporation
Computer Consoles Incorporated
Computervision Corporation
Computone Systems, Inc.
Concept, Inc.
Concord Fabrics, Inc.
Condec Corporation
Cone Mills Corporation
Congoleum Corporation
Conley and Kleppen Enterprises, Inc.
Consolidated Foods Corporation
Consolidated International, Inc.
Consolidated Protective Coatings Corporation
Consortium of Appliance Manufacturers for Export
Consyne Corporation
Container Corp. of America
Containerhouse
Contempra Industries Inc.
Continental Grain Company
Continental Insurance National Bank
Continental Textile Corp.
Conwood Corporation
Cook Industries, Inc.
Copeland Corporation
Copperweld Corporation
Coppus Engineering Corporation
Matt. Corcoran Company
Corenco Corp.
The Cornelius Company
Corning Glass Works
Corwill International
Courier Corporation
Craig Corporation
Crankshaft Machine Company
H. E. Crawford Co., Inc.
Crocker National Corp.
Crompton & Knowles Corporation
Crosby Valve & Gage Company
A. T. Cross Company
The Cross Company
Crossfield Products Corp.
Crossroads West Corporation
Crossville Rubber Products, Inc.
Crouse-Hinds Company
Curtis Industries, Inc.
The Cyclotron Corporation
Cyprus Mines Corporation
DNE Sales International, Inc.
Dage Corporation
Dalemark Industries, Inc.
Dallas Market Center Company
Dan River Inc.
Daniel Industries, Inc.
The Danzig Floor Machine Corporation
Data Card Corporation
Data General Corporation
Data Terminal Systems
Datamedia Corporation
Datapoint Corp.
Dataproducts Corp.
Datascope Corporation
Davies and Company
Davis & Furber Machine Company
Dayco Corporation
Dayton International, Inc.
Decor-Lite Corporation
Deere & Company
Delta & Pine Land Company

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Dennison Manufacturing Company
Den-Tal-Ez, Inc.
Dentsply International Inc.
Deon Equipment Company, Inc.
Derrick Manufacturing Corporation
Detex Corporation
Detroit Switch, Inc.
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
A. B. Dick Company
Digital Equipment Corporation
Dollinger Corporation
Donaldson Company, Inc.
Doolan Steel Company
Dorsey-McComb Inc.
Dow Chemical Company
Drake America Corporation
Draper Brothers Company, Inc.
Dreis & Krump Manufacturing Co.
Dresser Industries, Inc.
Drexel Chemical Company
Drexelbrook International Inc.
Dreyco, Inc.
Louis Dreyfus Corp.
W. B. Dunavant & Co.
Duplex Laboratories, Inc.
E.I. du Pont de Nemours & Company
Dura Electric Lamp Co., Inc.
Durametallic Corporation
The Duriron Company, Inc.
Duro Dyne Corporation
Dynabrade, Inc.
Dynaloy, Inc.
Dynamet, Inc.
Dynamics Research Corporation
Dynatech Corporation
EB-Way Corporation
EDO Corporation
EG & G, Inc.
E&L Instruments, Incorporated
ESB Incorporated
ESCO International
E-Systems, Inc.
Eagle-Picher Industries, Inc.
Eastern Air Lines, Inc.
Eastern Process Instruments
Eastman Kodak Company
Eaton-Allen Corp.
Eaton Corporation
Eberline Instrument Corporation
Echlin Manufacturing Company
E. Edelmann & Co.
Educational Innovation Systems International Inc.
Egan Machinery Company
Electric Furnace Company
Electro-Craft Corporation
Electron Fusion Devices, Inc.
Electronic Memories & Magnetics Corp.
Elgin National Industries, Inc.
Ellcon-National, Inc.
The Ellison Co., Inc.
Elmwood Sensors, Inc.
Embassies International, Ltd.
Emcee Electronics
Emerson Electric Company
Emery Industries, Inc.
Empire Abrasive Equipment Corporation
Empire Bias Binding Co., Inc.
Engelhard Minerals & Chemicals Corp.
Engineering Equipment Company
Environmental Tectonics Corporation
Envirotech Corporation
Erie Strayer Company
Esmark, Inc.
Ethyl Corporation
Eurotec International, Inc.
Eurotherm Corporation
Evans Products Company
The Eversman Mfg. Company
Ex-Cell-O Corporation
Export Agencies International Corp.
Extec International Corporation
Extracorporeal Medical Specialties Inc.
FMC Corp.
F. W. International, Inc.
John Fabick Tractor Company
Factor Motor Co. of N.Y., Inc.
Fairfield Manufacturing Co., Inc.
Fallek Chemical Export Corporation
Farah Mfg. Co., Inc.
Edward J. Fay & Associates, Inc.
Federal-Mogul Corporation
Federal Paper Board Company, Inc.
Feibus-Gordon & Company
Fenton International, Inc.
Ferno-Washington Inc.
Ferrex International, Inc.
Ferrostaal Pacific Corporation
The Fibre-Metal Products Co.
Fibreboard Corporation
Filmtronics, Inc.
Fire Systems, Inc.
Firestone Tire & Rubber Company
First Mississippi Corporation
First National Bank of Louisville
Fischer & Porter Company
Fischer Scientific Co.
Flagstaff Corp.
Flexi-Wall Systems
Flight Insulation, Inc.
The Flintkote Company
Florida Machine & Foundry Co.
Flowers Industries, Inc.
John Fluke Mfg. Co.
Fluor Corporation
Fluorescent Products, Inc.
Flying Tiger Line, Inc.
Food Automation—Service Techniques, Inc.
Forbex Corporation
Forté, Dupee, Sawyer Co.
Foster Bros. Mfg. Co.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Foster Wheeler Corp.
Four-Phase Systems, Inc.
The Foxboro Company
Franklin Electric Co., Inc.
Freeport Minerals Company
H. B. Fuller Company
Fuller O'Brien Corporation
Fuqua Industries, Inc.
GAF Corporation
GCA Corporation
GRM Corp.
Galaxy Carpet Mills, Inc.
Paul G. Gallin Co., Inc.
Galveston-Houston Company
Gardner-Denver Company
Gardner Laboratory Inc.
Garlock Inc.
The Garrett Corporation
Gates Learjet Corp.
Geering International
General Cable Corporation
General Dynamics Corp.
General Electric Company
General Glass Equipment Company
General Glass Imports Corp.
General Host Corp.
General Mills, Inc.
General Signal Corp.
General Solar Corp.
General Staple Company Inc.
General Telephone & Electronics Corporation
GenRad, Inc.
Geon Industries, Inc.
George Engine Company, Inc.
Georgia-Pacific Corporation
J. Gerber & Co., Inc.
Gerber Scientific Instrument Co.
Gerome Manufacturing Company Inc.
Gettys Manufacturing Co., Inc.
J. T. Gibbons, Inc.
Gilbert Commonwealth Companies
Gilford Instrument Laboratories, Inc.
Gilmour Manufacturing Co.
Glamorise Foundations, Inc.
Glasrock Products, Inc.
Gleason Works
Globe-Union Inc.
Milton Gold & Company
Norman Goldstein Associates, Inc.
Good Samaritan Laboratories, Inc.
Goodpasture, Inc.
Gorman-Rupp Co.
Gould Inc.
Gould Pumps, Inc.
Graniteville Co.
Gray Tool Company
Great Lakes Chemical Corporation
Great Northern Nekoosa Corporation
E. D. Green Corp.
Greene, Tweed & Co.
Grinnell Fire Protection Systems Company, Inc.
Richard-Louis Grosse & Co., Inc.
Grotnes Machine Works, Inc.
Grove Mfg. Co.
Grumman Corporation
Guardian Packging Corp.
Gulf & Western Manufacturing Company
H-B Instrument Company
H&D Transmission Service International, Inc.
HLB Export Limited
HNU Systems, Inc.
Hach Chemical Company
Hadley-Peoples Mfg. Co.
Halcon International, Inc.
Hale Fire Pump Company
Frank B. Hall & Co. of Georgia, Inc.
Hall-Russo
Halliburton Services
J. Hamilton Textiles, Inc.
Denslo F. Hamlin, Associates
Hammermill Paper Co.
J. L. Hammett Company
Hampden Engineering Corporation
Hankison Corporation
Hanlon & Wilson Company
Hardware Designers, Inc.
Harnischfeger Corporation
Harper & Row Publishers, Inc.
Harris Corp.
Harris Manufacturing Co., Inc.
Harris Trust and Savings Bank
Jacob Hartz Seed Company, Inc.
John Hassall, Inc.
Hayes-Albion Corp.
Hazelett Strip-Casting Corporation
Heath Tecna Corporation
Heil Co.
Albert Hekler
Helix Technology Corp.
Walter E. Heller & Co.
Hennessy Industries Inc.
Henningsen Foods, Inc.
Henry Valve Company
Herco Industries Inc.
Hercules Incorporated
The Herman Corporation
Hesston Corporation
High Vacuum Equipment Corp.
Hill-Whisnant International, Inc.
Hinds International, Inc.
Hobart Brothers Co.
Hobart Corporation
Hobbs International Ltd.
Hockman-Lewis Limited
Hoffman Electronics Corporation
Joseph B. Hoffman, Inc.
Hollay & Co., Inc.
Hollis Engineering, Inc.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Hometech Modular Housing Systems, Inc.
Honeywell Inc.
Hooker Chemicals & Plastics Corp.
Hoover Universal, Inc.
H. E. Hori, Incorporated
Horix Mfg. Co.
Horizon International, Inc.
Hostetter Marine Management, Inc.
Houdaille Industries, Inc.
S. Howes Company, Inc.
T. G. Howland International Co., Ltd.
Hudson Photographic Industries, Inc.
Huggins Export Co., Inc.
Hughes Tool Co.
Hull Corporation
Hunkar Laboratories, Inc.
Hunt-Wesson Foods, Inc.
Hy-Gain Electronics Corp.
Hyer Industries, Inc.
I Squared R Element Co., Inc.
ICA Export Co., Inc.
ICD Group Inc.
IDL Incorporated
IPCO Hospital Supply Corp.
ITC Enterprises, Ltd.
Identicon Corporation
Illinois Tool Works Inc.
Incomex (DISC)
Incoterm Corporation
Indian Head Inc.
Inductotherm Industries, Inc.
Industrial Boiler Company
The Ingersoll Milling Machine Company
Ingersoll-Rand Company
Inland Container Corp.
Innova Corporation
Instrumentation Laboratory, Inc.
Instrumentation Specialties Company, Ltd.
Interactive Radiation, Inc.
Interamerican Trade Associates
Intercontinental Associates Inc.
Intercontinental Publications, Inc.
Interkem Inc.
Intermarket Corporation
International Alltex Corporation
International Commodities Export Company
International Contractors Supply Company
International Flavors & Fragrances, Inc.
International Harvester Company
International Marine Products, Inc.
International Packaging Corporation
International Paper Company
International Telephone & Telegraph Corporation
International Trade & Services
InterTrade Scientific Inc.
Ionics Incorporated
Irrigation & Industrial Development Corporation
Irvin Industries, Inc.
Richard D. Irwin, Inc.
JB International Marketing Corporation
JLG Industries, Inc.
Jacobson Manufacturing Co., Inc.
Jacuzzi Bros., Inc.
Jademar Industrial Company
Jaeco Pump Company
Jamesbury Corp.
Jefferson Screw and Bolt Industries, Inc.
Jerome Industries Corporation
Jewel Company of America, Inc.
Jewett International Corporation
Curt G. Joa, Inc.
Johanson Manufacturing Co.
Johns-Manville Corporation
Johnston International Publishing Corp.
I. S. Joseph Company, Inc.
Joy Mfg. Co.
K&O Engineering Corporation
K–U.S.A. Inc.
KYBE Corporation
Peter A. Karl, Inc.
Karnish Instruments Inc.
Kearflex Engineering Company
Kearney-National, Inc.
Kearns International
Kellogg-American, Inc.
Kelvinator Commercial Products, Inc.
Kemeny Overseas Products Corp.
Kendavis Industries Int'l. Inc.
Kennametal Inc.
Kenney Manufacturing Company
Kerr-McGee Corporation
Kershaw Manufacturing Co., Inc.
Kewanee Industries, Inc.
Key Pharmaceuticals, Inc.
Keystone Consolidated Industries Inc.
Walter Kidde & Company, Inc.
George, W. K. King & Associates
King Instrument Corporation
King Meat Packing Company
King Plow Company
Kingsbury Machine Tool Corporation
W. S. Kirkpatrick & Co., Inc.
Kirsch Co.
Kloster Research & Development
Knogo Corp.
Koehn Manufacturing, Inc.
David Koetser Company, Inc.
Samuel B. Kogen Associates, Ltd.
Kolberg Manufacturing Corporation
Kollmorgen Corp.
Koppers Co., Inc.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Kraemer Mercantile Corporation
Kreidler-Shell Inc.
Kuhlman Corp.
Kwik-Way International, Inc.
Kysor Industrial Corp.
L&E International
LND, Incorporated
LSB Industries, Inc.
The LTV Corporation
LaFrance Export Corporation
The LAKSO Company, Inc.
Lambda Instruments Co., Inc.
Laminated Glass Corporation
Langston Companies, Inc.
La Pointe Industries, Inc.
Laster International, Inc.
Latrobe Steel Company
Lawrence Packaging Supply Corp.
W. D. Lawson & Company
Lawson-Hemphill, Inc.
Le Mare International (DISC) Corp.
Leach Manufacturing Co.
Lear Siegler, Inc.
The Leavitt Corporation
Ledex Inc.
Lee Pharmaceuticals
Leesona Corporation
Lennox Industries Inc.
Libby, McNeill & Libby
Liggett Group Inc.
Linatex Corporation of America
Lincoln First Banks Inc.
Lipe-Rollway Corporation
R. A. Litkenhaus & Associates, Inc.
Little Giant Pump Company
B. S. Livingston Export Corporation
The Lockformer Company
Lockheed Aircraft Corp.
LogEtronics Inc.
Lomma Enterprises, Inc.
Look International, Inc.
Lord Corporation
Lou Ana Industries International, Inc.
Louisiana-Pacific Corporation
The Loveshaw Corporation
Ludlow Corp.
Ludlow Industries, Inc.
Lukens Steel Company
Lummus Industries, Inc.
M/K Systems, Inc.
MPC Industries
MSI Data Corporation
MTD Products, Inc.
MTS Systems Corporation
Machine Technology, Inc.
Maclane International
Macmillan, Inc.
Madison Industries Inc.
Magnetic Controls Company
E. D. Magnus & Associates, Inc.
H. Maimin Co., Inc.
Maison International Ltd.
Malia International Ltd.
Mallinckrodt Inc.
Manitowoc Co., Inc.
Mannington Mills, Inc.
Marchado Laboratories, Inc.
Marden Wild Corporation
Marion Power Shovel Company, Inc.
Markem Corporation
Marotta Scientific Controls, Inc.
Marsh Stencil Machine Co.
Marshall Export Corporation
J. D. Marshall International, Inc.
Jim Martin Tire Co.
Martin-Marietta Corporation
Maryland Cup Corporation
Massachusetts Foundry Inc.
Massey-Ferguson Inc.
Materials Distributors Corp.
Matko Sales Corporation
Jas. H. Matthews & Co.
Mays Manufacturing Co.
McDonnell Douglas Corporation
McGraw-Curran Lumber Co., Inc.
McGraw-Edison Co.
McIlhenny Company
J. Gibson McIlvain Company
McJunkin Corp.
McNally Pittsburg Manufacturing Corp
McQuay-Perfex Inc.
Mead Corp.
Measurex Corp.
Mechtron International Corporation
Medical Coaches Incorporated
Medical Instrument Research Associates, Inc.
Medical International Company, Inc.
Medrad, Incorporated
Melax Manufacturing, Inc.
Meloy Laboratories, Inc.
MEM Company, Inc.
Memorex Corporation
Merck & Co., Inc.
Metropolitan Wire Corporation
Michigan General Corporation
Microdot, Inc.
Microlife Technics
Micromeritics, Inc.
Midland-Ross Corp.
Midwest Soya International Inc.
Milano Brothers International
Miller Associates
Milton Bradley Company
Milton Roy Company
Mine Safety Appliances Company
Miracle Adhesives Corporation
Miranol Chemical Company, Inc.
Mobile Drill International, Inc.
Mobile Fabrics, Inc.
Modern Industrial Engineering Co.
Moeller Manufacturing Company, Inc.
The Mogul Corporation
The Monarch Machine Tool Company

Appendix A—Continued

Membership of Special Committee for U.S. Exports—Continued

Monsanto Company
Montrose Chemical Corporation of California
Moog Inc.
George C. Moore Company
Moore Special Tool Co., Inc.
Morey Machinery, Inc.
Morgan Construction Company
Mossburg International, Inc.
Motch & Merryweather Machinery Co.
Motorola, Inc.
Mueller International Sales Corp.
Multivox Corporation of America
The Myers Group, Inc. Corporation
NCR Corporation
NL Industries, Inc.
NSC International, Inc.
NUS Corporation
Nadler Stainless & Alloy Corp.
Nadler Tube Corporation
Nalco Chemical Company
NAP Incorporated
Napco Industries, Inc.
Narco Scientific Industries, Inc.
Nashua Corporation
National Church Supply Co., Inc.
National Distillers and Chemical Corporation
National Forge Company
National Machinery Company
National Mine Service Company
National Nickel Alloy Corporation
National Starch and Chemical Corporation
National Valve & Mfg. Co.
Navidyne Corporation
Navigation, Inc.
A. R. Nelson Co., Inc.
Neptune International Corporation
New England Nuclear Corporation
New Hampshire Ball Bearings, Inc.
New Way Packing Machinery, Inc.
New World Research Corporation
Newpark Resources, Inc.
Niagara Falls Metals & Minerals
Nicolet Instrument Corporation
Norcross Corporation
Norris Industries
North American Philips Corporation
Northern Natural Gas Company
Northern Petrochemical Company
The Northern Trust Company
Northrop Corp.
Northwest Airlines, Inc.
Northwest Cold Pack Company
Northwest Engineering Company
Norton Company
Nova Clutch, Inc.
Nova Reed Corporation
Oak Industries Inc.
Oberg Manufacturing Co., Inc.
Observa-Dome Laboratories, Inc.
Ocean Chemicals, Inc.
Ocean Research Equipment, Inc.
Ocean Transport Systems Limited
Ohaus Scale Corporation
Oilgear Co.
Olin Corp.
Omega Engineering Inc.
Oneid Ltd.
OPICO
Opto Mechanik, Inc.
Optronics International Sales Corporation
Kurt Orban Company, Inc.
Oshkosh Truck Corporation
Outboard Marine Corporation
Overseas Development Corporation
PCR, Inc.
PMC Industries, Inc.
PPG Industries
PVO International Inc.
PACCAR, Inc.
Pace Packaging Corporation
Pacific Lumber Co.
Package Machinery Co.
Packaging Industries
Pak-Mor Manufacturing Company
Pan American Trade Development Corp.
Park-Air Corp.
Parkans International, Inc.
Parker-Hannifin Corporation
Parker Laboratories, Inc.
Parker Pen Co.
The Ralph M. Parsons Co.
Peabody International Corp.
Peachtree Doors, Inc.
Peavey Company
Pecora International Corporation
Pegasus International Corporation
Pertec Computer Corporation
Phifer International Sales, Inc.
Philip Morris, Inc.
Photo Marker Corp.
Physio Control Corporation
Pioneer-Leimel Fabrics, Inc.
Pioneer Transit Mixer Corporation
Piper Aircraft Corp.
Pittsburgh Brass Manufacturing Co.
Platt Saco Lowell Corporation
Plymouth Rubber International Co., Inc.
Pneumo Corp.
Pope & Talbot, Inc.
Portadrill, Inc.
Portec Inc.
Porter Paint Co.
Portsmouth Terminals, Inc.
Possis Corp.
Poultry Health Service
Powell Manufacturing Company, Inc.
Power Curber International, Ltd.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Precision Multiple Controls, Inc.
Precision Universal Joint Corp.
Prentice-Hall, Inc.
Price Y Cia., Inc.
John Prior, Inc.
Production Machinery Corporation
Products International
Pugh and Company
Quality Marsh International
Quanex Corp.
Questor Corporation
RCA Corp.
RFL International, Inc.
R P B Industries, Inc.
RPM International, Inc.
RSM Co.
Radatron Corporation
Rainbow Manufacturing Company
Ransburg Corporation
Ray Go, Inc.
Raypak, Inc.
Raytheon Company
Read & Emmerich, Inc.
Red Comet International Inc.
Redken Laboratories, Inc.
Rego Company
Reichhold Chemicals, Inc.
Reliance Electric Company
Reliance Universal Inc.
Remington Arms Co., Inc.
Renlew Import-Export
Repco Inc.
Repeat-O-Type Mfg. Co. Inc.
Republic Steel Corporation
Resource Systems, Inc.
Revco, Inc.
Rexham Corp.
Rexnord Inc.
Richmond Engineering Company, Inc.
Rio Del Mar Fools, Inc.
Riviana Foods, Inc.
R. Robb International Associates, Inc.
Robertshaw Controls Company
H. H. Robertson Co.
Rockwell International
Rocky Mountain Export Co., Inc.
Rogers Corporation
Rohm & Haas Company
Rohr Industries, Inc.
Roldan Products Corporation
Romanoff International Ltd.
Roper Corporation
Rossville Yarn Processing Company
Rototron Corporation
Ruvo Automation Corporation
SCM Corporation
SKC Inc.
SKF Industries
St. Augustine Trawlers, Inc.
St. Joe Paper Company
San Fernando Electric Manufacturing Company
Sandy Hill Corporation
Eli Sandman Co.
Sauereisen Cements Company
Schroeder Brothers Corporation
A. Schulman, Inc.
Science Accessories Corporation
Scientific-Atlanta, Inc.
SCOPE Incorporated
Sea-Land Service, Inc.
Seagrave Corporation
Seald-Sweet International
Sealed Power Corporation
Seatrain Lines, Inc.
Selby, Battersby & Co.
The Sentry Company
Sepco International, Inc.
Services International Ltd., Inc.
Servco Corporation of America
Sharoubim International Co.
Shatterproof Glass Corporation
The Sherwin-Williams Company
Sier-Bath Gear Company, Inc.
Sierra Research Corporation
Sigma Corporation
Sigma Industries Export, Inc.
Signode Corp.
Simons-Eastern Company
Simplimatic Engineering Co.
J. R. Simplot Company
The Singer Company
Singer Products Company Inc.
Skil Corp.
John C. Sleater Co. Inc.
Smith, Kirkpatrick & Co., Inc.
Snap-On Tool Corporation
Sola Basic Industries Inc.
Solar Innovations
Silitron Devices, Inc.
Son-Chief Electric Inc.
Sonnet International
Sonoco Products Co.,
Soundesign Corporation
Southern Alumnium Castings Company
Southern Cross Engineering
Southern Industries Corp.
Southern Machinery Corporation
Southwest Forest Industries, Inc.
Southwire Company
Soypro International, Inc.
Spang Industries, Inc.
Special Products Lab
Spectra-Physics, Inc.
Spencer Foods, Inc.
Sperry Rand Corporation
SPEX Industries, Inc.
Springs Mills, Inc.
Square D Company
Sta-Rite Industries, Inc.
Stanadyne, Inc.

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Standard Electric Company, Inc.
Standard Oil Company of California
The Standard Products Company
Standex International Corp.
Star Line International Inc.
Stauffer Chemical Company
J. C. Steele & Sons, Inc.
Steelmet, Inc.
Sterling Drug Inc.
Henry Stern & Co., Inc.
Jacob Stern & Sons, Inc.
J. P. Stevens & Co., Inc.
Stewart-Warner Corp.
Stone Construction Equipment, Inc.
Lewis J. Stone Company
Storage Technology Corporation
Fred C. Strype International, Inc.
Sturm, Ruger & Company, Inc.
Sugardale Foods, Inc.
Sun Chemical Corporation
Sunair Electronics, Inc.
Sundstrand Corporation
Superior Cable Corporation
Supradur Manufacturing Corporation
Supreme Equipment & Systems Corp.
Surel International
Sutton Engineering Company
Swan Manufacturing Corporation
SWECO, Inc.
Sycor, Inc.
Sylvan Ginsbury Ltd.
Systron-Donner Corporation
T. K. Valve Manufacturing, Inc.
TRW Inc.
Tab Products Co.
Talley Industries, Inc.
Tappan Company
Taylor Machine Works, Inc.
Starke Taylor & Sons, Inc.
Technical Operations, Inc.
Technitrol, Inc.
Techno Corporation
Tecumseh Products Co.
Teknis, Inc.
Teknor Apex International, Inc.
Teledyne, Inc.
TeleSciences Inc.
Templeton, Kenly & Company
Tenneco, Inc.
Testing Machines Inc.
Texaco Inc.
Texas Eastern Corporation
Texon, Inc.
Texstar Automotive Distribution Group, Inc.
Thayer Scale-Hyer Industries, Inc.
Thermo Electron Corporation
Thiokol Corp.
Thomas Built Buses, Inc.
The Mark Thomas Company
Tiffany Industries, Inc.
Timberline International Inc.
Tonka Corp.
Toro Company
Toroid Corporation
A. Torres Export, Inc.
Tower Manufacturing Corporation
Townsend International F.S. Company
Traco Industrial Corporation
TradeCom International Inc.
Traffic Dispatch International, Inc.
The Trane Co.
Trans American Consultants Inc.
Trans World Communications, Inc.
Transammonia, Inc.
Transportation Parts Company of New York, Inc.
Trimble House Corp.
Trion, Inc.
Tropical Export Honey Company
J.M. Tull Industries, Inc.
Twitchell Corporation
II-VI Incorporated
Tyrone Hydraulics, Inc.
UOP Inc.
Unaworld Corporation
Uni-World Industries Inc.
Uniflite, Inc.
Uniflow Manufacturing Company
Union Camp Corporation
Union Carbide Corporation
Union First National Bank of Washington
Union Oil Company of California
Union Special Corp.
Uniroyal, Inc.
Unit Process Assemblies, Inc.
United Export Corporation
United Industrial Corp.
United Merchants & Manufacturers, Inc.
U.S. Export Sales Corporation
United States Filter Corp.
U.S. Industries, Inc.
United States Supply Co., Inc.
United Technologies Corporation
Unitrode Corporation
Unival Export Corporation
Universal Leaf Tobacco Co.
Universal-Rundle Corporation
Universal Sports Corporation.
The Upjohn Company
Upson Tools, Inc.
VSI Corporation
Valeron Corp.
Valley Steel Products Company
Valleylab, Inc.
Valsan International Corporation
Valtec Corp.
Van Dorn Co.
Van Dusen Air Inc.
Vanderbilt Export Corporation

APPENDIX A—Continued

Membership of Special Committee for U.S. Exports—Continued

Varian Associates
Verson Allsteel Press Co.
Vesuvius Crucible Company
Vetco Inc.
Vickers-Pringle International, Inc.
Vicon Industries, Inc.
Victor-Balata Belting Company
Victor Comptometer Corporation
Virginia Chemicals Inc.
Virginia Transformer Corp.
Visual Graphics Corporation
Frederick von Raab Ltd.
Vulcan, Inc.
Vulcan Tool Manufacturing Company
Vydec, Inc.
WRG Corporation
Wachovia Bank & Trust Company, N.A.
Maxwell Wakely & Company
Walker Magnetics Group, Inc.
Wallace-Murray Corp.
Walter Motor Truck Company
Ward Machine Co., Inc.
Warn International
Warner-Lambert Company
The Warner & Swasey Company
Washington Fish & Oyster Co. of California
Waters Associates, Inc.
Watkins-Johnson Company
Waverly Press, Inc.
Wean United Inc.
Weatherhead Company
Weld Tooling Corporation
Wellco Enterprises, Inc.
Wells Mfg. Corp.
Wentworth Laboratories, Inc.
Wespac Corporation
Western Bancorporation
Western Gear Corp.
Western International Trade Corp.
Westinghouse Electric Corporation
Wexco International Corporation
Wheelabrator-Frye Inc.
Whip-Mix Corporation
Whirlpool Corporation
White Consolidated Industries, Inc.
White Motor Corp.
Whitehall Electronics Corp.
Whitfield & Company, Inc.
Whitford Corporation
Whitney-Fidalgo Seafoods, Inc.
John Wiley & Sons, Inc.
Williams Companies
Roger Williams Technical & Economic Services, Inc.
Williamson Corporation
T. D. Williamson, Inc.
Thomas C. Wilson, Inc.
Wiltron Company
Windsor Industries, Inc.
The Wise Company, Inc.
Wolff Manufacturing Company
Wolverine World Wide Inc.
Wonalancet International
Woodward & Dickerson, Inc.
World Commerce and Marketing Co.
World Markets Development, Inc.
Worthington Pump Corporation (U.S.A.)
Wyman-Gordon Co.
Wynn's Int'l., Inc.
XM World Trade Inc.
Xerox Corporation
Zapata Corporation
Zawnordo International
Zeus Industrial Products, Inc.
Zurn Industries, Inc.

SUPPORTING ASSOCIATIONS

Special Committee for U.S. Exports, August, 1978

AMTEX
Aerospace Industries Association
Air-Conditioning and Refrigeration Institute
Air Transport Association of America
American Association of Port Authorities
American Electronics Association
American Farm Bureau Federation
American Paper Institute
American Polled Hereford Assn.
American Quarter Horse Assn.
American Seed Trade Assn.
American Textile Machinery Assn.
Automotive Service Industry Assn.
The Brown Swiss Cattle Breeders Assn.
Cedar Rapids-Marion Area Chamber of Commerce
Chicago Association of Commerce & Industry
Connecticut Business and Industry Assn.
Electronic Industries Assn.
Emergency Committee for American Trade
Florida Department of Citrus
Great Plains Wheat, Inc.
Holstein-Friesian Assn. of America
International Business Center of New England
International Business-Government Counsellors, Inc.
International Economic Policy Assn.
International Executives Assn.
International Tax Institute, Inc.
International Trade Club of Chicago

SUPPORTING ASSOCIATIONS—Continued

Special Committee for U.S. Exports, August, 1978—Continued

International Trade Development Association
Leaf Tobacco Exporters Assn.
National Association of Manufacturers
National Association of Photographic Manufacturers, Inc.
National Association of Wheat Growers
National Cotton Council of America
National Council of Music Importers & Exporters
National Forest Products Assn.
National Grange
National Potato Council
National Soybean Processors Assn.
Overseas Automotive Club, Inc.
Plains Cotton Cooperative Assn.
Potato Board
Poultry & Egg Institute of America
Rice Millers Association
Scientific Apparatus Makers Association
Tobacco Associates, Inc.
United Fresh Fruit and Vegetables Association
United States-Mexico Chamber of Commerce Association
Western Wheat Associates
World Trade Association of Philadelphia, Inc.
Writing Instrument Manufacturers Assn., Inc.

APPENDIX B

EXCERPTS FROM LETTERS REGARDING DISC

Ajax International Corporation, Santa Barbara, California:

We have been utilizing this program for several years and feel it to be a most positive benefit for our company doing business in the international market. As a small manufacturer, we have found the DISC to be very important and of positive assistance to our company's growth.

Alox Corporation, Niagara Falls, New York:

While our company has been in the export business prior to the establishment of DISC's, the existence of our DISC has helped us to remain competitive, particularly in the European market . . . While we are a small company, approximately 40% of our sales are for export. Any significant loss of such export sales would materially influence our employment level here in Niagara Falls.

The formation of a DISC was one of several factors which prompted our abandoning plans to construct a European manufacturing facility. If DISC's are eliminated, we will have to reinstate those plans.

American Livestock Producers International, Inc., Flora, Indiana:

[W]e feel it is a vital part of our needs to have the benefits of this taxation program. International marketing is expensive and carries a great deal of risk and of course our country needs the exports for a balance of trade. In view of this we think this taxation program is not only advantageous, but necessary to our country.

Antex, Inc., Attleboro, Massachusetts:

Since its inception in 1971, DISC has been quite a help to us. As a small exporter we have been able to establish ourselves securely with the extra capital made available to us because of the reduction in income tax liability afforded through DISC. In fact, if DISC was repealed at this time, we feel we would suffer in our business, as we would have less funds to work with.

It seems that we are paying already enough taxes and that, rather than help the Government's budget, the repeal of DISC would actually hurt since, if business suffers, there will be less total income to be taxed.

If DISC is repealed, we will find ourselves having to think twice before spending and investing, which in turn will affect our suppliers and customers, who will look for materials elsewhere.

The Austin Company, Greenville, Tennessee:

[T]he DISC legislation has provided us the opportunity to offer more extended credit terms and to carry larger commodity stocks, both of which have been extremely helpful in competing in the international trade field in tobacco.

Autodynamics, Inc., Neptune, New Jersey:

Autodynamics formed a DISC in 1975. Since the formation of this DISC, our export sales went from essentially nil to between fifty and eighty-five

percent (50% and 85%) of our business in the past two years. Autodynamics is a fairly young and growing company and the tax benefits derived from the DISC have been very beneficial in helping us to grow.

Automated Building Components, Inc., Miami, Florida:

Analysis we have made indicate that the small difference that the D.I.S.C. provides, makes it feasible for us to manufacture many items here instead of overseas for our export markets. Without the D.I.S.C., many items we manufacture in the United States would be manufactured in their foreign countries.

Baltek Corporation, Northvale, New Jersey:

Our company, while small . . ., has benefitted from the special features of DISC over the past five years. Our export sales in 1976 were over four times what they were in 1972 and we firmly believe that one of the contributing factors in this increase was the tax benefits afforded to us by the DISC.

The Beaton & Corbin Manufacturing Company, Southington, Connecticut:

We indirectly relate to several other major exporters. Their export business contributes to our domestic activity. DISC provides the incentive needed to compensate for the efforts of exports and directly adds to the volume of non-participating suppliers.

Blue Spruce International, Stirling, New Jersey:

Through DISC, it has been possible for us as a small company to exist in a highly competitive field. If we had relied solely upon domestic business, we would have been out of business long ago.

Burr-Brown Research, Tucson, Arizona:

Two hundred Burr-Brown employees hold their jobs because of export sales.

In addition, approximately 180 jobs exist in other U.S. companies because of the service, supplies and materials we purchase in support of our export sales. Our export sales through DISC are also, indirectly, tremendously profitable to the Federal government.

The U.S. government has collected an estimated $1,400,000 in income taxes during the last three years in return for deferring $121,000 of income taxes as provided by the DISC law.

CAFCO International Limited, Stanhope, New Jersey:

CAFCO International Limited is a DISC subsidiary of U.S. Mineral Products Company and the first year of operation was fiscal 1972–1973. Since then, the DISC features of the Internal Revenue Code have proved to be of great assistance in maintaining normal levels of capital investment to the parent company's operation through improved net earnings. There is no doubt that the increased earnings from the DISC operation have also helped us to continue exporting from the U.S.

In 1971, U.S. Mineral Products Company was seriously considering investing in a European manufacturing facility to satisfy European, North African and Middle East demand for our products. However, since the inception of the DISC features, it proved to be beneficial to continue exporting from the U.S., and maintain the normal level of employees without mass entrenchment.

Canberra Industries, Inc., Meriden, Connecticut:

Canberra Industries is a relatively young, high technology company which manufactures instrumentation used in measuring various types of radiation. In the last five years, our sales have quadrupled and in 1977, we expect to have worldwide sales of our instruments totalling approximately 20 million dollars. Approximately 50% of our business is sold to customers outside of the United States. Over the last several years the growth of our export business has exceeded the growth rate of our domestic business, and we feel that the tax benefits obtained from the DISC has played a significant role in allowing us to finance and develop this growth in our export business. As is true of many small high technology, fast growing companies, one of our major problems is how to finance our rapid growth. The cash which has been made available by existing DISC legislation has played an important role in allowing us to achieve our present sales position, and there is no question that elimination of the DISC tax benefits would make it more difficult for us to compete in the overseas market.

Castaldo Products Manufacturing Corporation, Westport, Connecticut:

We are a small DISC company that exports jewelry manufacturing supplies and grosses about $500,000 a year, thus bringing in valuable foreign ex-

cnange and strengthening our country's trade position. Almost all of our export trade has developed since we formed a DISC operation in 1972, and the law has been both an encouragement and an advantage for us.

Concept, Inc., Clearwater, Florida:

Concept, a small manufacturer of medical/surgical products exports 15 percent of its production . . . Without incentives to export, we would need to substantially reduce our production capacity and labor force.

Concord Fabrics of America, New York, New York:

Concord Fabrics is interested in mantaining and expanding our sale of textile fabrics in the world market. The benefits of the DISC features of the Internal Revenue Code is of meaningful help to us in that endeavour. If it were not for these special features we would have to curtail our foreign trade efforts, curtail our participation in ternational fairs and sales trips to foreign markets.

Coppus Engineering Corporation, Worcester, Massachusetts:

We have been involved in exporting for many years and have received two Presidential "E" awards in exporting.

We created a DISC five years ago and it has been of considerable assistance to us in trying to maintain a high level of exports, which we have accomplished.

Unfortunately, the 1976 Tax Reform laws have severely limited DISC. There still remains some stimulant for exporters and we hope no further cutbacks are made, but rather that those already made may be restored.

In 1971, our foreign sales were two million dollars and in 1976, were six million dollars. During this period, our export-related jobs went from 63 to 116.

Our export sales are already more costly than domestic sales and we need more incentives to export more rather than less. With worsening balance of payments, it is surprising that DISC incentives for exporters were reduced.

We are a small manufacturers located in Worcester, Massachusetts, and appreciate the value of DISC and urge that DISC provisions be reinstated to pre-1976 tax law levels.

Crosby Valve & Gage Company, Wrentham, Massachusetts:

We formed a DISC in March 1972. It has been of important assistance to us in providing the working capital needed to expand our export sales. In our fiscal year 1972 our exports amounted to $1,242,000 and represented 14 percent of our sales. In 1976 our exports were $6,442,000 representing 21% of sales, and until recently we have expected this nice trend to continue. One main problem we have always had with exports is that they tie up far more working capital than domestic sales because foreign customers on average take 3 to 4 times longer to pay our invoices. The $400,000 in taxes which our DISC has enabled us to defer . . . provided less than half of the cumulative extra working capital we needed to support the $5,200,000 increase in 1972–1976 exports but we were a small company and for several years we had severe financial problems and it sure helped.

The clouds now on our horizon are that our foreign competition has increased very noticeably in the past year, in domestic as well as foreign markets, prompted partly by evidently direct and indirect subsides by foreign governments and partly by changes in exchange rates. If DISC incentives are removed in face of this we will certainly find it discouraging.

CWJ Farms, Inc., Gainesville, Georgia:

We are a comparative small exporter with annual sales of approximately five million dollars in fertile hatching eggs and related poultry products. Even though this may seem small to others, it is big to us.

In the mid-sixties we saw the opportunity for a significant increase in sales of our products for the years ahead but because of considerable risk and limited capital we did not pursue expansion. Then we learned of the benefits as provided by DISC and in a period of four years we have more than tripled our export sales. We feel proud that we have contributed in a small way toward a favorable balance of payment in world trade.

Datamedia Corporation, Pennsauken, New Jersey:

Since we are a privately-held corporation, our access to funds for expansion is limited. Because of the tax deferral benefits afforded by DISC, we have been able to increase sales by 584 percent and earnings by 784 percent over five years since 1973. Our export business has contributed 40 percent of our total sales since Datamedia formed a DISC subsidiary.

Dan River, Inc., Greenville, South Carolina:

This feature has been very important to us in promoting textile exports at a time when we are being inundated by textile imports.

Davis & Furber Machine Company, North Andover, Massachusetts:

I have become acutely aware of the lack of support [for exports] by our government in face of the fact that European nations and Asian nations are today aggressively involved in government subsidies for exports. At times, I wonder if our government is even slightly aware of the benefits of export trade.

I have had personal experience with several small companies who, were it not for DISC legislation, would never have considered entering into export market. True, they did it for financial advantage but, at the same time, their businesses grew rapidly and their products met the needs of developing nations. It is inconceivable to me how an argument against DISC can stand up in view of the fact that export incentives and direct government subsidies to foreign exporters seems to be the game plan of the day.

Doolan Steel Company, Moorestown, New Jersey:

We are in the steel distribution field. For years we have maintained an active export department. We employ approximately one hundred and seventy-five people and 20 percent to 25 percent of our business volume is direct export.

We find it increasingly difficult to compete in the world markets and we need all the encouragement we can get. DISC is a great source of encouragement and was probably the best piece of foreign trade legislation passed by Congress in this century. To repeal DISC would be a terrible mistake and, in fact, its benefits should be broadened.

Drake America Corporation, New York, New York:

Our company was constituted as a DISC when the tax legislation was passed, and since 1972 the volume of our overseas sales has more than tripled. Much of this growth was due to more intensive sales and marketing activity overseas, the very type of activity encouraged by the DISC tax legislation.

Drexel Chemical Company, Memphis, Tennessee:

We are a small company of approximately 20 employees which is engaged in the production, marketing and trading of agricultural chemicals. Our DISC subsidiary, Drexel, Inc., is a key part of our business and exports will average 20–30 percent of our total company sales. The DISC provisions have been a major reason for our emphasis on exports as it afforded us a means of increasing our working capital and net worth at a faster rate than would otherwise be possible. This in turn has allowed our company to expand both in domestic and export markets.

Dynaloy, Inc., Hanover, New Jersey:

We have been an active exporter and have an associated DISC corporation which we formed in 1972.

As a small company we have found the tax benefits very helpful and because of them have invested in further export-related activities to increase usage of our products overseas.

Dynamics Research Corporation, Wilmington, Massachusetts:

DISC is a most attractive feature of exporting. We are relatively new to exporting, having started only a year ago, but we are hopeful that over the next three to five years we will be able to build one-quarter to one-third of our sales from overseas.

DISC will certainly play an important role in financing this expansion to our sales and in making possible the addition of people and plant to support those sales.

With all the export incentives offered by competitor nations, the availability of DISC for American firms, I believe, is an important element in making American firms competitive internationally. If anything, the United States has to do even more to encourage exporting if the United States is to be on an equal footing export-wise with its competitor nations.

Eaton Allen International Ltd., Brooklyn, New York:

Our parent company, Eaton Allen Corporation, is manufacturing a wide range of products in the field of office supplies, like the KO REC TYPE brand correction materials, Typing and Correcting Ribbons, including ribbons for the IBM machines, carbon papers and films, etc. While the mentioned brand became a household word in the U.S.A., there have been no efforts to

enter the field of exports due to foreign competition, import duties abroad, and high taxes at home. A decision has been made to form our exporting company only after the enactment of the Disc provisions with the idea of taking advantage of the incentives of the Disc rules. From a modest start in 1972 our export business has developed into a sizeable volume.

However, due to the drastic amendments of 1976, and continuing agitation to abolish the Disc benefits altogether, coupled with very significant foreign incentives, our parent company is currently in negotiations to establish a foreign manufacturing base for the supply of the existing foreign demand, and for the expansion of sales abroad on the largest possible scale.

The realization of the mentioned project would mean, of course, the winding up of our own exporting activities, coupled with all the adverse effects of reducing production, and jobs in the plant of our parent in Brooklyn, New York.

Educational Innovations Systems International, Inc., Fontanna, Wisconsin:

We are a small firm which was formed under the DISC rules and we have grown rapidly since our incorporation in 1969 as a domestic corporation and in 1972 as a DISC corporation. Currently we are doing over $9 million in sales. We would probably be operating at a much lower volume if it were not for the DISC rules.

Ferno-Washington, Inc., Wilmington, Ohio:

Our company formed a Domestic International Sales Corporation in 1972. Since that time, our exports have almost tripled in volume. The DISC incentive was responsible for part of this growth. The added cash accumulation enabled us to finance and encourage additional sales volume.

We now have full time representatives in the Far East and in Europe. Our export sales now account for 20 percent of our business. During the fiscal year of 1977–78, we anticipate that our export sales will exceed $2,000,000. In terms of jobs, this represents approximately 75 jobs.

Our products are enthusiastically received in over 20 countries worldwide. We are especially hopeful of making inroads in Europe where, heretofore, our volume and market penetration have been limited to non-EEC countries with the exception of the UK. We might also add that we enjoy a substantial sales volume in Japan, which is a country that most United States manufacturers find difficult competition-wise.

Fire Systems, Inc., White Plains, New York:

We would discontinue our export activities if DISC were to be abolished.

Four-Phase Systems, Inc., Cupertino, California:

Four-Phase Systems organized a DISC in 1972 when the company had very few export sales. Due to the incentives provided by the DISC, among other things, our export sales have grown to approximately 20 percent of our total revenues.

Frequency Sources, Inc., Chelmsford, Massachusetts:

Although our company is relatively small ($10 million annual), we have developed a significant portion of our business through foreign customers. The establishment of DISC provisions in 1971 provided an additional incentive for us to more aggressively seek export business and was instrumental in our establishing a new sales organization solely dedicated to expanding our foreign business base.

GRM Corporation, Medford, New Jersey:

This particular vehicle permits us the necessary incentive and competitive edge required to conduct more export sales. Our efforts are primarily directed to the sale of telephone equipment and air traffic control systems all over the world, and hence the DISC permits us to spend more dollars in advertising and direct sales effort than we would normally spend on domestic customers.

General Staple Company, Inc., New York, New York:

We are a small company with sales of $2 million, who decided to expand our export operations solely because of the DISC legislation. About 1½ years ago, and as a direct result of this DISC legislation, we opened up an office in Japan and another in Belgium—and proceeded to start up a selling operation.

Imagine our surprise and subsequent chagrin to find that less than a year after we started the operation that Congress had decided to chop the benefits. I am convinced that the DISC laws increase American employment and have a direct positive effect on the balance of payment situation.

Gettys, Racine, Wisconsin:

GETTYS is a small company (should ship about $11 million worth of industrial control systems in 1977) which exports approximately 50 percent of its output.

In 1972 we were close to establishing a manufacturing arm in Europe when we decided to establish a DISC instead.

We can prove that the taxes collected as a result of the jobs created here in the U.S. by our exports more than offset the "loss" in revenue to the IRS because of our DISC. In other words, DISC, for GETTYS, did exactly what the legislation creating it had intended it to do.

If the DISC is abolished, almost certainly GETTYS will have to reassess its decision to manufacture only in the U.S.

Grip Blanking, Union, New Jersey:

We are a small organization of eight people but due to the advantages of the DISC program, we actively sought out opportunities for export of American machinery. . . . Shortly after this, the bureaucrats decided to kill DISC. I lost interest in selling overseas because without DISC it would be extremely expensive for any firm—no matter what its size was. I, therefore, put our export program into the mothballs.

HNU Systems, Inc., Newton Massachusetts:

HNU System is a three-year old manufacturer of new technology instrumentation for chemical analysis whose export sales have grown to better than 20 percent of total sales revenue. We feel that this number can be almost doubled within the next two years with the appropriate addition of sales and marketing programs dedicated to export activities. However, without the partial deferment of U.S. income tax on export earnings provided by the DISC, we will certainly not be able to make those investments.

Harris Manufacturing Co., Inc., North Billerica, Massachusetts:

We are a small company employing under 40 people. . . . The DISC has helped us tremendously and should it be terminated or drastically changed, it would seriously affect our ability to continue growing in our overseas market. Today our DISC operation constitutes a substantial part of our total gross sales and is increasing yearly.

High Vacuum Equipment Corporation, Hingham, Massachusetts:

We have had a DISC subsidiary for approximately five years now and certainly feel that its incorporation and the benefits therefrom have contributed to our financial growth.

Joseph B. Hoffman, Inc., New York, New York:

The DISC incentive allowing a reduction in income tax liability on qualified export earnings resulted in freeing capital which enabled this company, for one, to invest in new and innovative machinery which has, and will continue to expand our production and business interests not only in this country but throughout the world.

King Instrument Corporation, Westboro, Massachusetts:

Since 1968, we have manufactured machines to spool magnetic tape into both audio and video cassettes. We earned an "E" for export efficiency in 1972 and now, based on sales growth, we have applied for our "E Star."

In the last nine years we have grown from five to forty employees. Exports have been a constantly increasing percentage of our business reaching 75 percent in 1976. The DISC is helping us to finance our growth from our earnings. While we constantly read about the need for increased exports, and we learn what other countries do for their exporters, we find it hard to understand the reasoning of those who want to take away this modest incentive to obtain sales abroad. There must be many other small companies that would be exporting if there were genuine incentives offered.

King Plow Company, Atlanta, Georgia:

Although we have just recently formed our DISC, it was a major factor in our decision to export in earnest. Without this incentive, we will most probably cut back in our efforts to sell overseas.

The Loveshaw Corporation, Deer Park, New York:

Although The Loveshaw Corporation is a very small company in terms of total dollar volume of sales, we have very successfully been exporting mostly to Western Europe and have found that the DISC has been our main incentive towards this exporting effort.

Should the DISC be discontinued, we would probably have to reevaluate our total export effort and curtail most of it. Let us not forget that export sales do require a much higher effort than domestic sales and therefore, that they should permit a higher percentage of return.

MPC Industries, Irvine, California:

We formed a DISC in July of 1972 which has been continuously used since that time. We are involved in the manufacture of press and caul plates made from specially melted, type 410 heat treated stainless steel manufactured in the United States which we polish and chrome-plate to the customer's specifications. These plates are used in the manufacture of high pressure decorative laminates and wood products all over the world. We are competing with Swedish, German and Italian manufacturers and the DISC is a viable means to help us meet their competition.

MPC Industries was recently awarded the Department of Commerce E Star Award for increased exports and we attribute part of this success to our ability to use the DISC.

As a small manufacturer, we know the value of any incentive which our government can give us to meet the subsidized competition we face from other countries.

MTS Systems Corporation, Minneapolis, Minnesota:

Close to fifty percent of our sales are in international markets. Most of our competition in these markets is based outside of the United States. Our DISC has played a significant role in the profitable development of these markets and in the growth of this corporation, and has been most helpful in the continuing effort to win orders from foreign competition.

Machine Technology, Inc., East Hanover, New Jersey:

The creation of the DISC vehicle enabled us to compete aggressively in the international market for our goods. Without the incentive provided by DISC legislation we would not have been in a position to effectively compete.

Approximately 25 percent of our business is now done overseas, whereas in prior years our overseas business accounted for only 5 percent of yearly shipments.

Marine Colloids, Inc., Rockland, Maine:

As the first Maine-based company to form a DISC (our DISC began business in January 1972), we have experienced export sales of over 40 percent of our annual sales of approximately $22,000,000.

We feel DISC definitely has played an important part in our increased export efforts and as such would not want to see the abolishment of the DISC provision of the Internal Revenue Code.

Markem Corporation, Keene, New Hampshire:

Markem is a small, but worldwide company, and one-third of the jobs in our domestic operation are directly the result of our export business. The cash generated from deferred federal taxes resulting from the operation of our DISC is a significant factor in our commitment to international business and exporting in particular. Being in the export business is more costly than straight forward domestic operations, and the DISC provisions of the tax law are helpful in maintaining our export competitiveness and increasing the number of domestic job opportunities resulting from those exports.

Michael E. McDaniel, Lawrenceville, Georgia:

We established a DISC account in April of 1972.

Since that time our exports have increased from only 10 or 15 percent of our total business to over 45 percent of our current business. Doing business outside the United States is extremely difficult, because the discounts we must give in order to obtain distributors, and the expenses involved are higher than those we give in domestic territories. In order to sell profitably outside the United States on the same level as domestic sales, the establishment of a DISC was necessary, because the export sales then became attractive. We were able to spend more time and energy to expanding our efforts. Over the years we have had a large increase in the people here, many of whom were added because of our increase in export sales. This year we are talking about doing 2 to 3 million dollars worth of sales outside the United States. We would have never been able to have come this far, had it not been for the DISC. This amount of money, albeit small, is a significant portion of our income. If the DISC law is repealed, we will have less money to spend for promotion, which will of course result in a downturn in our sales.

The Miranol Chemical Company, Inc., Irvington, New Jersey:

We have always made an exceptionally strong effort to boost our export sales because of my personal commitment to that type of trade. We have further gone out of our way to use U.S. flag ships to carry our exports and the biggest boost to our efforts has been the DISC treatment under which we established Miranol International as a DISC corporation. If the advantages of DISC treatment were to be removed, our export sales will not only be curtailed drastically but they might, to all extents and purposes, be killed.

We export well over 20 percent of our total production and for a small company that is well above average. Based on the advantages of DISC we have incurred heavy promotional expenses pointing to our competitive situation.

To remain a viable exporter, Miranol International must retain the DISC advantages or fail.

Mobile Drill International, Inc., Indianapolis, Indiana:

DISC status has, indeed, stimulated the growth of our company and certainly the sale of our products overseas. We presently maintain a 40–50 percent ratio on exports versus domestic sales, and we hope to grow in this area to an even greater extent during future years. We do feel quite strongly, of course, that the tax deferral available to our subsidiary under DISC is critical to our growth and expansion.

The manufacturing and sales of our company's products engages approximately 100 employees, and as you can see from the figures mentioned above, we rely quite heavily on export sales. The value of this part of our business most certainly benefits our employees, our city and our country as well.

George C. Moore Company, Westerly, Rhode Island:

Elastic Export Sales, Inc., serves the export needs of George C. Moore Company and its eight U.S.A. subsidiaries and divisions. Since its incorporation five years ago, we have seen our export sales grow at a faster rate than the domestic market.

We also have a wholly-owned subsidiary in the Republic of Ireland which was established after we were unsuccessful in competing with the tariff barriers established by the EEC. The continuation of these foreign tariffs, duty drawbacks, tax credits, etc., should make the need for export support by the U.S. Government that much more evident.

Neslab Instruments, Inc., Portsmouth, New Hampshire:

Neslab is a small manufacturing firm whose DISC corporation is in its third successful year. The incentive of deferred tax payments, so important to a small corporation, has helped us to boost outside U.S. sales to 30 percent of our total.

Ocean Research Equipment, Inc., Falmouth, Massachusetts:

ORE is typical of the many small U.S. companies (annual sales less than $4 million, 40 percent export) who have depended on DISC-generated tax deferrals to help offset the high costs of doing business overseas.

Orban Export, Inc., Wayne, New Jersey:

The Kurt Orban Company has been active in international trade for over thirty-five years. Though the bulk of our business is importing to the United States, we have been trying very hard to assist U.S. manufacturers in exporting their products. The existence of the DISC incentive was a significant factor in deciding whether or not we wanted to invest in an export company.

Pace Packaging Corporation, Fairfield, New Jersey:

Pace Packaging Corporation is a small company employing 17 people. We have formed a DISC corporation, and, largely as a result of the tax benefits gained therefrom, we have expanded our export sales so that now they approximate one-half of our total volume.

Prime Tanning Co., Inc., Berwick, Maine:

We established a DISC on July 12, 1972. Since its inception, the DISC has spurred our export activity. The small incentive that has been offered us through this law has allowed us to take some additional risks. We have hired new agents around the world; set up a new office in Europe; and invested in sampling all over the world. As pointed out above, slowly and steadily our export business has grown.

We certainly hope the government will not be so shortsighted that in these days of negative trade balances for the U.S., small companies like ourselves will lose the small encouragement which the tax laws have given us.

RFL Industries, Inc., Boonton, New Jersey:

We are a small manufacturer of specialized electronic equipment with approximately 20–25 percent of our business overseas. Creation of a DISC almost five years ago was a major factor in our increase in international sales. Should there be a repeal of DISC, we could expect a decrease in the amount of promotion we could afford pursuing our overseas markets. Unfortunately, our Congress does not realise that such a decrease will inevitably result in lower sales.

Services International Ltd., Ind., Gloucester, Massachusetts:

Ours is a young company, organized in 1970 and shipping today at the rate of approximately two million dollars per year. I can sincerely state that the survival and ultimate success of this company has been due in large part to the advantage offered us as a DISC corporation.

As one who sells in seventy countries around the world, I am constantly impressed by the export efforts of such countries as Japan and the U.K. and trust there can be little doubt in the minds of "anyone in the know" that if businessmen and government should even exert a fraction of the effort of such countries we could overwhelmingly dwarf the efforts of all our overseas competition.

Singer Products Co., Inc., New York, New York:

Since our first year under DISC, when our volume was $11,500,000, we have increased our volume for the calendar year 1976 to $23,500,000. This increase was made possible to a very great extent by the increase in financial facilities which we had available as a result of the utilization of deferred tax funds. We were enabled to open overseas offices, to greatly expand our promotional activities, and to offer increased and more advantageous credit facilities to our customers.

We would like to point out that this increase in sales took place in the face of shrinking markets, particularly in the last two years, as a result of greatly increased protectionist measures and foreign exchange restrictions in many of our markets for many of the products which we sell.

Henry Stern & Co., Inc., Hartsdale, New York:

As combination export managers, our company has introduced products of the small or intermediate size manufacturer of electrical materials to markets throughout the world. These manufacturers, either because of lack of familiarity with foreign credits or because of shortage of necessary capital, expect us to pay them and extend credit terms to foreign accounts. The amounts per transaction are too small to warrant government financing and our margin of profit too small to permit us the luxury of bank financing and credit insurance.

Only the tax deferral features of DISC enable us to accumulate some capital of our own to support our sales program. The termination of DISC would sharply curtail our ability to offer conditions to our buyers that will make the high-priced American goods practical for them to purchase.

Techno Corporation, Erie, Pennsylvania:

Though Techno is a small firm in terms of international sales, we have established sales representation in several foreign countries since the formation of our DISC. This expanded marketing effort is a direct result of DISC incentives and we like to think we have made some contribution—however small—toward improving the U.S. balance of trade.

Technical Operations, Inc., Boston, Massachusetts:

Our company formed a DISC two years ago and because of it much more emphasis is placed on obtaining export business than would otherwise be the case. While our present volume of exports is quite modest, we strongly support retention of the DISC feature in our U.S. tax laws.

Teknor Apex International, Inc., Pawtucket, Rhode Island:

Since we established the DISC in 1972, our exports have increased by well over 100 percent. While much of this growth may be attributed to our intensified export sales activity, there is no denying that a good deal of it is due to the facilities which DISC provides.

Testing Machines, Inc., Amityville, New York:

We have a DISC company which is partially responsible for our increased export sales of several hundred percent. Our sales philosophy now is to participate in overseas exhibits, the establishment of more aggressive represent-

atives and a willingness to extend more liberal credit terms. These efforts have resulted in the large percentage of our work force that is devoted to export sales.

Thayer Scale-Hyer Industries, Inc., Pembroke, Massachusetts:

While our company is small (employment less than 100), about 20 percent of our personnel owe their jobs to the increase in our export sales, which has been the direct result of the DISC incentive.

Uniflow Manufacturing Co., Erie, Pennsylvania:

We are a relatively small company and yet 21 percent of our business is export.

We have a DISC formed.

Because of DISC our company became more aware of exports and the export business we could do.

Because of DISC we devoted more time to export. As examples, we spent the necessary monies to have our literature printed in four foreign languages and English metric. We extended our co-operative policies such as advertising, direct mail, tradeshow, etc. to our overseas distributors. We expanded our overseas models in strictly 220 volt/50 cycle to include practically our entire line of products.

Because of DISC we did make a greater profit on foreign business and spent the extra time, money and effort because we would afford to do so, on our export business. The result has been steadily increased exports of our product.

Unit Process Assemblies, Inc., Syosett, New York:

We are a small manufacturing organization making sophisticated measuring instrumentation for quality control and inspection purposes by industry. About a third of our volume is for export, and we have been most encouraged by the DISC program.

Unival Export Corporation, South Boston, Massachusetts:

Be assured any action to change this law will affect our sales and reduce local employment. Our two companies, Swedman Controls Corporation and Rockwood Systems Corporation, in 1973 became active in the foreign market because of this incentive and have developed exports of approximately $600,000 a year, which added twelve people to our payrolls. Discontinuation of the DISC act would cause erosion of these jobs and also reduce the taxes we pay at the federal and state levels.

Valsan International Corporation, New York, New York:

We have had a DISC corporation for the past several years and have managed to double our export sales in this period as a result of the special tax advantages offered by the government for DISC corporations.

Whip-Mix Corporation, Louisville, Kentucky:

We are deeply and seriously involved in exports, and have been for over 25 years. In fact, our export sales exceed 40% of our total business volume. The original DISC legislation was gratifying to us, because our foreign competitors do enjoy certain advantages and privileges in their overseas operations, and DISC enabled us to compete more vigorously, specifically in third markets.

As an active member of the President's District Export Council, I have assisted other firms in our area in developing and increasing their export activities, and it certainly is discouraging to them and to our firm that the Tax Reform Act of 1976 has limited the incentive for expanding exports.

Actually, with the productive capacity of the U.S., we need more and better incentives to get more American firms interested in foreign trade. The markets are there, U.S. industry has the productive capacity, and we can increase the U.S. share of foreign trade, reducing trade deficits at the same time, but businessmen need the incentive.

Whitford Corporation, West Chester, Pennsylvania:

A few of us started this company seven years ago with nothing but an idea and a few dollars. We now have twenty-five employees, sales approaching $2,000,000 per year and about 25% of our business comes from outside the United States. The DISC feature of the Internal Revenue Code is a substantial incentive for us to aggressively promote our export sales. I'm sure it will also be a substantial consideration when we decide whether to supply overseas customers from the United States or from overseas manufacturing locations.

Zeus Industrial Products, Inc., Raritan, New Jersey:

We have operated our subsidiary, Zeus International Products, Inc., as DISC since 1972. Never actively seeking export sales previously, the DISC opportunity spurred us to seek out and solicit exports in both distribution and sales. Our reward has been the opportunity to postpone a modest amount of federal tax. Tax savings have not been more than 5% in any given year, usually ranging from 3 to 5%.

COMPARISON WITH PRACTICE OF FOREIGN COUNTRIES [1]

I. Disc in light of foreign country practices.
II. Value added tax.
III. Tax and nontax export incentives of six foreign countries.
A. Belgium
B. France
C. Germany
D. The Netherlands
E. Japan
F. United Kingdom

APPENDIX C

I. DISC IN LIGHT OF FOREIGN COUNTRY PRACTICES

In order to fully consider DISC, it is necessary to compare it with the treatment afforded by foreign countries to their exporters. While DISC appears in the U.S. Internal Revenue Code, it is much more than an internal U.S. tax measure. It is a very important element in the legal environment for U.S. exports which must compete with foreign produced goods. Congress would make a serious mistake if it looked at DISC solely as an element in the U.S. tax system and did not compare it with foreign provisions. Indeed, one of the reasons which led the Administration to propose DISC in the first place was the fact that producers in foreign countries could benefit from a multitude of foreign measures designed to encourage exports. While this represented a clear advantage to foreign companies, it also led U.S. manufacturers to move their manufacturing locations to foreign countries. In order to help keep production and jobs at home, and avoid serious losses to the U.S. economy and U.S. employment. DISC was proposed and enacted.

Foreign countries still maintain these measures to encourage exports. If the United States acted unilaterally and removed DISC at this time, it would reestablish a competitive disadvantage for American exports, and again make it more attractive for American manufacturers to move their production facilities to these foreign countries which encourage exports.

Moreover, DISC assumes an even more important role now than it did at the time of its enactment in 1971 in that international trade negotiations are in process in Geneva. In his testimony on July 8, 1975, before the House Ways and Means Committee, the Secretary of the Treasury, William E. Simon, stated: "We have just commenced the multilateral trade negotiations in Geneva which we are hopeful will lead to international examination of tax incentives for trade and investment. Repeal of DISC prior to seeing the direction that these negotiations will take could prejudice our prospects for obtaining fair and uniform tax rules."

In connection with its testimony on DISC in 1971, the Treasury submitted to Congress information on foreign country practices which was printed in the record of the hearings of the House Ways and Means Committee and the Senate Finance Committee. In addition, in 1972 the Treasury commissioned an accounting firm and a law firm to further study the export practices of five foreign countries. An examination of this information leads one quickly to the conclusion that DISC is only a small boost to U.S. exports, when compared to international practice. While it is believed that most of the practices referred to in the 1971 and 1972 reports are continuing, the Special Committee for U.S. Exports has decided to review the current situation in a number of foreign countries and to make a further submission to the Committee with respect thereto. In the meantime we have secured permission from the Treasury Department to ob-

[1] This Appendix C updates a study prepared for the U.S. Treasury Department by an accounting firm and a law firm. The same professionals furnished information to make this Appendix current as of January 15, 1976.

tain copies of the 1972 reports, and based on those reports and the public record, augmented by limited additional research, we have analyzed below the measures in 6 principal competitors of the U.S.: Belgium, France, Germany, Japan, Netherlands, and the United Kingdom. We also have attached to this Statement an analysis of the Value Added Tax (II) and a country-by-country analysis of these practices which is drawn from the same sources (III).

In comparing these practices with DISC it is important to realize that DISC makes only two important changes in the U.S. taxation of export income. First, it permits U.S. tax on export income retained in a DISC (actually 50 percent of export income) to be deferred. Prior to 1963 the U.S. permitted export income to be deferred if earned through a foreign corporation. Such income can no longer be deferred because of Subpart F. Our principal competitors do not have such a provision except for Germany and Canada which have provisions a lot less strict. Thus, the first aspect of DISC partially restores the pre-1963 U.S. situation for exports which is much more like the rules in foreign countries. Second, DISC clarifies intercompany pricing rules so that if 75 percent of the export income is subject to U.S. tax, the remainder may be deferred in a DISC. This substitutes a specific rule for existing uncertainty in the U.S., and seems substantially less generous to exports than the practices of foreign countries.

Considering the actual effect of DISC in light of the foreign country practices discussed below, it becomes clear that DISC is not out of line with international norms and is generally much less of an aid to exports than the practices of other countries.

1. Nontaxation of foreign source income

A number of foreign countries do not tax or largely exempt foreign source income. Such provisions which were primarily intended to avoid double taxation of income have been used to provide a competitive advantage in international trade. Exports from such countries are often organized so that all or a large part of the income derived from the exports is treated as foreign source income (typically derived in a low tax or no tax country), and thereby escapes substantial tax in the home country or elsewhere. In comparison, in a typical situation with DISC, 75 percent of the income from manufacturing and exporting is taxed by the U.S. with tax on the remaining 25 percent deferred, not eliminated.

RULES FOR DIRECT EXPORTS

France totally exempts foreign source income from taxable income. In addition, foreign source income is defined in a very broad way so as to include any income derived from permanent establishments abroad, from operations abroad of dependent agents and from operations constituting a so-called "complete commercial cycle" outside France. Under the complete commercial cycle theory, a French company may derive nontaxable income without a permanent establishment or an agent abroad by simply conducting activities outside France.

In Belgium foreign source income is taxed at ¼ the rate applied to income from domestic sources, compared to ¾ taxation under DISC. Under Belgian law, income is from foreign sources as long as it has been generated abroad, that is, the activity which produces such income is earned abroad. There is a requirement that the income has been taxed abroad before it can benefit from the reduced rate. But this requirement has been interpreted broadly and any foreign tax at any rate meets the test.

In the Netherlands, a Dutch company is taxed on its worldwide income but it is almost never taxed in practice on income derived from a foreign branch. Foreign source income is taxable only if it has not borne a foreign corporate tax. The rate of such corporate tax is immaterial and it is not required that the tax has been actually levied, as long as it should have been levied in normal circumstances. In Germany most of the tax treaties totally exempt income derived from foreign countries.

Both in the Netherlands and in Belgium, losses of a foreign branch can be deducted from domestic profits, even though profits from that same establishment are not taxed or are partly exempt. The same is true of Germany even though the income from a foreign establishment is tax-exempt by reason of a tax treaty.

RULES FOR EXPORTS THROUGH A SUBSIDIARY

Income of foreign subsidiaries is never subject to tax in any of the countries considered. While this principle also applies in the United States, in the case

of U.S. exports through a foreign subsidiary, the U.S. is unlikely to provide an exemption because of the provisions of Subpart F of the Internal Revenue Code. Germany and Canada are the only other countries to penalize the establishment of subsidiaries in tax haven countries. When the foreign subsidiary of a U.S. corporation returns its profits to the U.S. in the form of dividends, the profits are fully subject to tax except for the foreign tax credit for any foreign taxes paid. In comparison a number of countries largely exempt dividends received from foreign subsidiaries. Both in France and in Belgium, the domestic companies are entitled to deduct 95 percent of the dividends received from their taxable income. In the Netherlands, any income received from a foreign subsidiary by its Dutch parent is fully tax exempt if it controls as little as 5 percent of the foreign company, and provided that the investment is related to the business activity of the parent. The exemption not only applies to dividends but also to such items as capital gains or interest.

USE OF RULES TO REDUCE TAXES ON EXPORTS

The advantages which can be derived from those foreign rules by those in the exporting business are obvious: by channeling all their exports through foreign based sales offices or subsidiaries located in tax haven countries, they can escape home country taxation on a substantial portion of their income. Moreover, the fact that foreign losses are deductible even though profits are not subject to tax is a great incentive toward the establishment of a new sales operation abroad. It substantially minimizes the cost of potential losses.

It should be recognized that a basic feature of DISC is to permit a U.S. exporter to export through an entity, the income of which is not subject to tax. It is very analogous to the foreign rules just discussed but it is much less generous. While under the foreign rules a permanent exemption usually applies, under DISC the exemption ends at the time of distribution or at the time of disqualification as a DISC.

2. Use of intercompany pricing rules to benefit exports

All countries considered here have provisions similar to section 482 of our tax Code related to the reallocation of profits between related entities to reflect arm's length dealings. But foreign countries have had a tendency to use this provision to benefit exports. In 1939, France had even issued an official Note to that effect, specifically stating that the intercompany pricing rules should generally not be enforced against exporting companies. The French authorities issued a new Note in 1972 and claimed that the new Note revised the special treatment for exports. However, an examination of the Note reveals that it simply repeats the policy stated in the previous one. A Note issued by the tax authorities in May 1973 affirms this position.

In Belgium, reallocation rules are infrequently invoked by the Tax Administration as long as the Belgian taxpayer realizes a normal profit. In some cases exporters have received formal assurances from the Tax Administration permitting a favorable allocation.

While in the Netherlands, the reallocation provisions are more strictly enforced, the taxpayer may negotiate advance agreements on pricing for exports. It would seem that a 10 percent margin on cost is the maximum percentage required. Even in Germany the strict enforcement of these rules has been relaxed from time to time where the German economy as a whole was involved or where exports at cost or at prices below cost permitted full utilization of the German parent's production capacity. In the UK, British companies can show that the activities of a foreign sales subsidiary will increase exports from the United Kingdom. Such assertions are known to have considerable influence on the attitude of the authorities toward low prices for exports to selected companies.

These reallocation rules are crucial in determining the extent to which the income from exports can escape tax or enjoy a low rate of tax. Given that foreign source income is in one way or the other substantially free of tax, if under the reallocation rules more of the income can be treated as foreign source income, more of the income enjoys no or low taxation. On the other hand, if reallocation rules are strictly enforced so that only a small part of the income is foreign source income, the benefits from the exemption or low rate on foreign source income is much less. Since the early 1960's the U.S. has strictly enforced

its section 482, against exporters as well as others, to assure that the prices in transactions with related companies, especially those in tax haven countries, are such that the U.S. taxes a share of the income based on arm's length prices. This strict enforcement has led to controversy, litigation and uncertainty. DISC, in effect, establishes a rule of thumb and ends the uncertainty in this area by providing that the U.S. will be satisfied if 75 percent of the total income is reported by the U.S. manufacturer, and subject to tax in the U.S. On the other hand, the rules with respect to a number of foreign countries are dramatically more generous to exporters requiring considerably less than 75 percent of the income to be taxed in the home country.

3. Specific Export Tax Incentives

In addition to the tax provisions allowing current deduction for foreign losses, Germany allows its domestic companies to constitute special reserves for losses incurred by a new foreign based company, be it a sales or manufacturing company. France has the same provision which applies to both sales offices and subsidiaries, while in Germany it only applies to acquisition or establishment of foreign subsidiaries. The reserve is gradually restored into income. Moreover, where a German company exports capital goods in exchange for an interest in a foreign company it is allowed a tax deferral on the profits realized by creating a deductible reserve which is gradually dissolved after five years.

In France, both banks and exporting companies are allowed to constitute deductible reserves to cover the risks inherent in the extension of credit. The duration and amount of the reserve are limited, but this system in practice allows an exporting company to defer a portion of its taxable income from exports indefinitely. In addition, substantial tax advantages are accorded to French companies which associate in a joint export program.

In Japan, direct export incentives are granted to domestic companies, including (1) reserves for overseas market development consisting of a deduction from taxable income of a certain percentage of profits derived from exports, (2) deductions for overseas investment losses, (3) deductions for foreign exchange losses, and (4) special deductions for certain overseas transactions.

4. Tax Incentives Indirectly Benefiting Exports

Every country is concerned with its balanced economic development at the industrial or the regional level. In order to encourage the development of certain industrial sectors or of certain depressed areas, all European countries grant tax incentives. While these incentives are not officially related to exports, in practice they often serve as additional export incentives. In a small country like Belgium, large industrial undertakings normally export the great bulk of their production so that any incentive for a substantial industrial operation is largely an export incentive. But that is not the end of the matter. The officials who administer the incentives, will determine to whom they can be granted. In France and Belgium, at least, the officials will typically inquire about the export plans of the applicant and it has been the general experience that the incentives are more readily available when there are plans for substantial exports. Set forth below is discussion of some of the very generous industrial incentives granted by some of the foreign competitors of the U.S. If they are recognized as incentives to export especially in the case of France and Belgium, the place of DISC in the international scheme of things can be more accurately judged.

In Belgium, an exemption from real estate taxes on fixed assets for a maximum period of five years and the permission to apply straight-line depreciation at twice the usually applicable rate for three years are granted to corporations which invest in certain depressed areas. Where it is considered that the investment generally benefits the economy, although it is not made in a depressed area, the exemption from real estate taxes is still granted for a maximum period of three years, provided the investor furnishes at least 50 percent of the investment from his own funds.

In France, numerous tax incentives are granted for developing depressed areas such as exemption from local business taxes and accelerated depreciation of construction costs.

In the Netherlands and Germany accelerated depreciation is available for assets invested in certain geographical areas. Germany allows lower income and corporation profits tax rates on the profits of a Berlin branch and special Value Added Tax concessions are made on goods manufactured in Berlin and shipped to the Federal Republic.

In order to promote capital investments, the U.K. also grants special tax incentives such as accelerated depreciation for industrial buildings, business plants and machinery.

5. Border Tax Adjustments to Benefit Exports

U.S. exporters are deeply concerned, with reason, by the border tax adjustment granted to European exporters. To explain the matter very briefly, European countries have generally adopted a turnover tax system called Value Added Tax (VAT) under which exporters obtain the rebate on exports of indirect taxes paid on the goods during processing while importers are liable for the same taxes on imports. It has never been denied that the VAT system worked as a special and effective export tax incentive. Indeed, no country, with the exception of Belgium and Germany, which, for a time, imposed a temporary additional tax on exports, has ever attempted to limit the effect of such benefits. On the contrary, the temporary limits constitute an admission of such an effect on exports. The French even eliminated in 1968 a special employer's tax replacing the lost revenues with VAT revenues. Since the VAT is refundable on exports, the practical effect was the elimination of the former tax for exports only.

The rebate of indirect taxes on exports has been allowed under international trade rules which were formulated at a time when economists believed that indirect taxes were always shifted forward in the price of the goods and direct taxes were never shifted forward. More sophisticated analysis indicates that shifting of tax burden does not so much depend on the type of tax as upon competitive market conditions.

In these circumstances, with rebates of indirect taxes permitted and rebates of direct taxes forbidden, a country with a comparatively higher indirect tax burden which is rebated on export has a distinct competitive advantage in international trade. This advantage is compounded in its own market by the imposition on imports of the same taxes that are rebated on exports.

Moreover, taxes should be viewed as an integrated phenomenon, bearing both on domestic and international economic and trade mechanisms. High rebatable sales tax rates compensated for by lower corporate and individual income tax rates allow corporations competitive prices on the international market as well as cheap additional capital funds for investments which in turn improve their competitive capacity on the international market.

The Congress has indicated its serious concern over this state of affairs. In the Trade Act of 1974, it directed the President to seek a "revision of the GATT Articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs." DISC was established to offset some of the tax advantages which foreign exporters enjoy and to make production here for export attractive.

Until this is achieved the DISC serves as a valuable counter to the present advantages enjoyed by overseas exporters.

6. Specific Nontax Export Incentives

All countries included under this study have government-related agencies comparable to the Export-Import Bank of the United States (Eximbank) which support their exports. Negotiations have been conducted between the principal trading nations and also through the Organization for Economic Cooperation and Development (OECD) in an attempt to equalize the terms of financing and insurance coverage for export transactions thereby minimizing any competitive advantage of one country over another. No agreement has been reached as of now, negotiations are continuing.

In all of the countries exports are financed either through the use of direct loans, guarantees, insurance or credit refinancing depending upon the type and size of the transaction involved. For example, medium term export sales (180 days to five years) receive support through insurance, guarantees and refinancing of medium term commercial bank loans in the United States and in the U.K. Japan usually issues guarantees or direct loans directly to Japanese suppliers. Germany and France provide medium term support by way of insurance and refinancing of credits extended by their suppliers. Medium term credits are extended directly to buyers by the United States, U.K. and France. There is evidence that the rates offered by the U.K. Japan and France are subsidized whereas the rates offered by Eximbank are fairly close to the market rate of interest.

Long term export sales are usually supported by way of direct loans. In some instances the supporting department or agency makes direct loans directly to suppliers within their own country whereas in others the direct loan is made to the buyer of the goods and services. Eximbank extends long term credit only to foreign buyers of U.S. goods and services. It does so in participation with commercial banks. This results in a combination of direct loans by Eximbank and financial guarantees covering loans made by the commercial banks. Most of the other countries extend the direct loan to their own supplier as well as in fewer instances to the buyer of that country's goods and services. Except for Germany, interest rates charged to foreign borrowers are the highest in the United States. As of December 1975, these rates ranged as follows: France 7.5 percent; U.K., 7.8 percent; Japan, 7.5–8.7 percent; Germany, 10 percent; United States, 8.25–9.5 percent.

Eximbank support on a direct loan basis applies to a relatively low percentage of the contract price when compared with other countries' practice. It is Eximbank's policy to lend directly between 30 percent and 55 percent of the contract price and its total support will range up to 80 percent including financial guarantees. Others will lend directly on these long-term sales as follows: Germany, up to 77 percent; U.K., 80 percent to 85 percent; France, 90 percent. Moreover, in France and Japan exporters are granted so-called "mixed loans" which are a combination of normal commercial terms with special favorable terms and interest rates on a variable portion of the loan.

Some of the other export credit agencies offer specialized coverage through guarantees or insurance which is not offered by Eximbank. This coverage includes insurance against inflation and the issuance of performance bonds in the U.K. and insurance against exchange rate fluctuations offered by the agencies of the U.K., Germany, France and the Netherlands.

In addition, the French agency COFACE insures all risks attached to the development of new foreign markets as well as the expenses of presenting new products at international fairs. Also it will finance administrative technical assistance through specialized government subsidized organizations. These organizations routinely provide a number of services to exporters for which minimum fees are charged such as market studies, organization of fairs, business conferences and legal assistance, etc.

7. Nontax Incentives Indirectly Benefiting Exports

In addition to tax incentives, most foreign countries grant nontax incentives to promote industrial and regional economic development. As already mentioned, these incentives may be more easily obtained in certain countries like France or Belgium where exporting activities are involved. Even where this is not the case, these have a favorable impact on export trade in general.

These incentives are mainly carried through direct cash grants by which the governments finance a varying portion of qualifying investments. In addition, interest may be partly financed by the government in Belgium and in the Netherlands where the loan has been granted for the purpose of investment in a depressed area. In France, and in the United Kingdom a number of investments of special economic interest are permitted to be financed at advantageous interest rates. Also, France has special programs to cover a major part of the expenses connected with training and decentralization of business operations. Belgium has a similar program for training of unskilled labor.

II. The Value Added Tax

All European countries which are members of the European Economic Community, have adopted a uniform turnover tax system: The Value Added Tax (VAT).

VAT is an indirect tax borne by the ultimate consumer. Instead of collecting the sales tax in a lump sum at the retail level, the tax is levied in installments whenever taxable transactions are carried out by taxable persons. The tax applies to all deliveries of goods and rendition of services in the course of the entire production and distribution process (including the retail stage). The amount of tax collected on the final consumer would be equal to the amount of tax levied in a lump sum at the retail stage, assuming the rates were the same. Therefore, VAT provides only a different procedural system for the collection of sales tax. The system works as follows, assuming a 10 percent tax:

	S1	P2	P2	P3	Total
Cost	0	1,000	1,500	2,000	
Value added	1,000	500	500	500	2,500
Total	1,000	1,500	2,000	2,500	
Tax collected	100	150	200	250	
Tax paid	0	100	150	200	
Government receipt	100	50	50	50	250

Each purchaser pays a tax based upon the cost of goods purchased (so-called "input tax"). Such cost does not include the tax paid by the seller to his previous seller. When the purchaser sells the goods after transformation, he collects the tax from his purchaser (so-called "output tax"). The "output tax" offsets the "input tax". The excess of the "output tax" over the "input tax" is turned in to the government which ends up receiving the same amount of tax as if the tax had been levied in a lump sum at the final stage. When the last purchaser is a foreign person, the seller does not levy the "output tax" since the tax has a territorial scope. Therefore, the "input tax" cannot be offset. If the exporter was deemed to be exempt from the VAT, he would get no reimbursement for the VAT paid in the purchase of goods exported. However, the European system is to consider that the sale by the exporter is subject to a 0 percent sales tax and, as a result, exporters are entitled to a reimbursement of the VAT levied upon the cost of goods purchased for export. This is the so-called "zero rating" system.

Before the VAT System, all European countries practiced a cumulative turnover tax system. Exporters were entitled to a rebate equal to the amount obtained by applying the sales tax rate upon the export price. If the rate in effect was 7%, the exporter would receive a rebate equal to 7% of the export price. But because of the cumulative effect, the total tax on goods to the consumer was generally higher and the exporter had to include in his sales price the amount of taxes not rebated. Therefore the VAT system, although not directly aimed at encouraging export, has had a favorable impact on export prices.

Moreover, in most of the VAT countries, "franchise" systems are provided so that an exporter can purchase at a zero rate goods or material which are destined for exportation. This has a significant impact on the cash flow of the enterprise.

BELGIUM

The VAT system was adopted in Belgium in 1969 but was applicable only as from January 1, 1971. The standard rate is 18 percent. The maximum rate on luxury items is 25 percent. Exports are subject to a zero rate and exporters can fully recover the VAT paid on purchases and services rendered in connection with the goods exported. The "franchise" system is allowed for goods and materials imported, either to be re-exported as such or after having been processed.

FRANCE

The VAT system was gradually introduced in France after the Second World War for purposes of simplification and minimizing tax fraud. The rates range from 7 percent for basic consumer goods to 33⅓ percent for luxury goods. The rate applied on most transactions is 20 percent. France has also adopted the zero rating system by which exporters may recover the amount of taxes levied upon purchases of goods and services made in connection with the manufacturing or sale of goods to be exported. The "franchise" system is different from the one applicable in Belgium. Any exporter can avail himself of the "franchise" upon the purchase in France of any good to be exported as such or to be transformed into finished products destined for exportation. The "franchise" cannot exceed the amount of the value of his VAT zero rated exports in the preceding fiscal year.

GERMANY

Germany introduced the VAT System in 1968. Most transactions are taxed at an 11 percent rate. It has also adopted the zero rating system. But in order to reduce the degree of incentives Germany levied a special turnover tax in 1968–1969 of which there could be no rebate. As in Belgium, the "franchise" system is allowed for goods which are shipped to Germany for processing and are then shipped out of Germany to a non-Common Market country.

THE NETHERLANDS

The Netherlands introduced the VAT System in 1969. The applicable rate is 16 percent although a reduced rate of 4 percent applies to most food products. It also applies the zero rating system. The zero rate is also available if a product is exported directly by the Dutch manufacturer of supplies on behalf of the Dutch exporting company, provided the latter gives the manufacturer or supplier a written export instruction.

UNITED KINGDOM

The VAT was introduced in 1973 as part of the harmonization measures taken in connection with the entry into the Common Market. The standard rate is now 8 percent. A maximum rate of 25 percent applies to luxury items. It was reduced from 10 percent to 8 percent on July 29, 1974. Like all other EEC countries, the United Kingdom applies the zero rating system to exports.

Direct Versus Indirect Taxes in International Trade

Border tax adjustments for indirect taxes are permitted under the rules of the General Agreement on Tariffs and Trade (GATT), Article VI(4), while GATT does not allow rebates on direct taxes. The GATT distinction was established at a time when most economists made the working assumption that indirect taxes are fully passed onto the consumer, while direct taxes are not.

In view of recent more sophisticated economic analysis, there is no doubt however that such working assumption has to be refined and qualified. A majority of economists agree today that direct corporate taxes do shift forward to the price of goods, as do indirect taxes such as the value added tax. The main disagreement left among these economists relates only to the extent and scope of such shifting. The difficulty with measuring the impact lies with the fact that the tax burden is only one factor to consider in computing a price and that the shifting of tax burdens in general, either backward or forward, may depend on a number of other factors such as the normal pricing methods of businessmen, the mobility of capital and labor, the elasticity of supply and demand of the goods produced, the state of the economy and the size of the firms in relation to their market.

Although these factors should not be overlooked, it becomes obvious that, when rebates of indirect taxes are permitted and rebates of direct taxes are forbidden, a country with a comparatively higher tax burden which is rebated on export has a distinct competitive advantage in international trade. This advantage is compounded in its own market by the imposition on imports of the same taxes that are rebated on exports.

Moreover, taxes should be viewed as an integrated economic phenomenon, bearing both on domestic and international economic trade mechanisms. High rebatable sales tax rates are generally compensed for by lower corporate and individual income tax rates or burdens. This is the case in most European countries where corporations bear a lower corporate tax burden than in the United States. This results from lower corporate tax rates, exemption of foreign source income from corporate tax, various tax reliefs which have no counterpart in U.S. tax law, and, especially in the case of France, extensive tax fraud. Therefore, exporting corporations located in these countries are not only permitted to practice better competitive prices on the international market but they are also "given" cheap additional working capital available for investments, which in turn, improve further their competitive capacity in international trade. In a sense, it could be said that domestic consumers, who bear the high sales tax rates, "subsidize" the exported production.

The Congress has indicated its serious concern over this state of affairs. In the Trade Act of 1974, it directed the President to seek a "revision of the GATT Articles with respect to the treatment of border adjustments for internal taxes to

redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs." DISC was established to offset some of the tax advantages which foreign exporters enjoy and to make production here for export more attractive.

Until this is achieved the DISC serves as a valuable counter to the present advantages enjoyed by overseas exporters.

III. Tax and Non-Tax Export Incentives of Six Foreign Countries

A. Belgium

I. Tax incentives

1. Taxation of foreign source income.

(a) *Rules for direct exports.*—Under Belgian domestic law, foreign branch profits and foreign source real property income are taxed in Belgium at a reduced rate. Such income must have been "generated abroad," that is, the activity which produces such income must be conducted abroad, and in the case of foreign branch profits, it must have been taxed abroad. The rate of tax is not relevant nor are any special rules exempting the income from foreign tax as long as the income is actually or should have been taxed at regular rates. The reduced rate is one-fourth the rate applicable to income from domestic sources, meaning that presently, foreign source income is generally taxed at a 12 percent rate. Foreign taxes can be deducted from taxable income. Under most Belgian tax treaties foreign source income is exempt from tax in Belgium. Foreign branch losses are fully deductible by the domestic parent even though income of the branch would be exempt from tax in Belgium under a tax treaty. Certain rules apply regarding the order in which foreign losses may offset taxable profits. If the loss is incurred in a non-treaty country, the loss is applied first against foreign source income from non-treaty countries, secondly against foreign source income exempt by treaty and thirdly, against Belgian source income. If the loss is incurred in a treaty-country, the loss is applied first against foreign source income exempt under the tax treaty, secondly, against foreign source income from a non-treaty country, and thirdly against Belgian source income. If the Belgian operation results in a net loss, the loss is applied first against Belgian source income then against foreign source income from a non-treaty country, and thirdly against foreign source income exempt by treaty.

(b) *Rules for exports through a subsidiary.*—Income from a foreign subsidiary is not taxable in Belgium and there is no provision comparable to Subpart F of the U.S. Internal Revenue Code. Therefore, a Belgian company can freely take advantage of the establishment of a foreign sales subsidiary located in a tax haven country.

2. Use of intercompany pricing rules to benefit exports.

Unlike France, Belgium has no published circular with respect to intercompany allocations involving exports through a related company in a low tax country. Nevertheless, favorable intercompany pricing has been permitted by the Belgian government, especially in the late 1950's and early 1960's, as a means to encourage the establishment of export industries. Although the Belgian tax authorities have the power to reallocate profits under Article A.24 of the Belgian Revenue Code, it appears that, in practice, they have had considerable difficulty in obtaining adequate information to enforce that provision. Moreover, the Belgian government has issued formal letters to potential foreign investors with respect to intercompany allocations on exports which apply for a limited number of years. For example, the Belgian authorities have agreed to accept prices equal to cost plus 8 percent. These letters are sometimes extended. However, in recent years it has been more difficult, but not impossible, to receive such formal assurances and the profit required in Belgium will depend more on industry norms than in the past. Nevertheless, letters are still being issued.

3. Specific tax incentives indirectly benefiting exports.

(a) *Depreciation.*—No special depreciation or amortization is allowed on assets connected with the production of goods to be exported. However, such advantages are granted for other purposes which indirectly benefit the export industry. Special depreciation rates must be agreed upon with by the tax authorities which may allow degressive depreciation, accelerated depreciation and other special advantages. These advantages are mostly granted in connection with the development of certain depressed areas or industries. In various development areas, the cost of equipment, tools and industrial buildings can be depreciated at an annual rate which is equal to twice the normal straight line depreciation during a maximum period of three years.

(b) *Exemption from real estate taxes.*—The government may grant an exemption from real estate taxes on fixed assets for a maximum period of five years. As in the case of depreciation, this measure is primarily aimed at industrial and regional economic development. There is indication however, that the administration is usually strongly influenced by actual or potential exporting activities of an applicant.

(c) *Profits realized from the sale of fixed assets and shares.*—Profits realized on the sale of land and buildings, machinery, equipment and shares may be subject to a reduced income tax rate when the proceeds are invested in a development area within a period beginning 6 months before the tax period during which the profits are realized and expiring 12 months after the end of such tax period.

II. Nontax incentives

1. Nontax incentives directly benefiting exports:

(a) No import tax or custom duties are imposed on merchandise imported into Belgium, as long as it is reexported within a short period of time, and that it is not used or transformed in Belgium.

(b) Export financing: Belgian companies may discount commercial paper received in export transactions at a rate usually more favorable than that applied to commercial paper resulting from domestic transactions. Such rate is fixed and controlled by the government. Under governmental supervision, a special banking institution grants medium term export financing at rates competitive with other countries. A majority of loans at even more favorable rates is intended to encourage exports to developing countries. Besides, under the Compromex program, interest rebates are granted on export credits. The charge is borne by the government and the interest burden may be reduced, for instance, from 7 percent to 5 percent. The average rate of interest borne by the exporter is 9 percent.

(c) Credit insurance: A special government agency called the "Office National du Ducroire" insures long-term export credits against general commercial and political risks as well as any losses which might arise due to currency fluctuations. Coverage of risks ranges from 80 percent to 100 percent.

(d) Government subsidized services to exporters: Office Belge du Commerce Exterieur. This government agency provides for assistance to exporters in the following areas:

Market studies and planning;
Practical information regarding commercial regulations and techniques;
Publications;
Documentation (Diplomatic reports, statistics);
Legal help;
Advertising assistance;
Participation in commercial and industrial fairs; and
Organization of business conferences.

This organization grants assistance for export promotion to small and medium enterprises. It acts as a consultant for the company and might go as far as organizing a distribution network abroad, searching buyers, collecting debt, packaging, shipping and insuring goods for the exporter.

2. Specific nontax incentives indirectly benefiting exports:

(a) Stimulation of exports is not the primary purpose of the various subsidies granted by the government in order to develop investments and stimulate regional development. But such measures sometimes have the effect of encouraging exports because subsidies are more easily granted when the industry is a potential exporter.

(b) Among the incentives granted by the government are: Interest subsidy under which the government subsidizes a portion of the interest payable by the investor on the loan. The subsidy is generally 2 percent during a period of two years usually given on an amount between ⅓ and ⅔ percent of the investment in fixed assets. But when the investment is made in a development area, the rate of the subsidy can go up to 7 percent during a period of five years on an amount not exceeding 75 percent of the total investment cost.

Direct financing of investments in lands, equipment, machinery, and buildings;

Noninterest bearing loans of up to 50 percent of the proposed investment may be granted to finance research and development of new products and new production techniques to be employed in Belgium;

Financial assistance to meet the cost of training workers;

Government guarantees covering capital repayment, interest and other charges relative to medium term qualifying loans.

B. FRANCE

I. Tax incentives

France is certainly the most aggressive country, together with Japan, with respect to encouraging exports. It is one of the few countries which allows direct tax incentives to its exporters. Besides, its basic tax structure has an especially favorable impact on the export trade.

1. Taxation of foreign source income.

(a) *Rules for direct exports.*—Foreign source income is not subject to French income tax. Domestic source income is "all profits realized by enterprises exploited in France." As interpreted by the courts, foreign source income is therefore any income:

Derived from establishments abroad;

Deprived from operations abroad of dependent agents; and

Derived from operations abroad which constitute a "complete commercial cycle.

In other words, the exclusion applies to income derived from the direct and active conduct of a business abroad either by a French company or by a foreign company. As a result, income of the foreign subsidiary of a French company as well as income from a foreign establishment is not taxed in France because the profits are attributable to activities conducted abroad. Similarly, profits derived abroad by a French company's agent from strictly foreign activities are not taxed in France. Moreover, certain income is considered as foreign source income even though the French company has no establishment or agent abroad. This is the case of income derived from a "complete commercial cycle" abroad. The income derived by a French company purchasing goods in country A for resale in country B is excludable, but the contracts must usually have been negotiated andn executed outside France.

(b) *Rules for exports through subsidiaries.*—Income of a foreign subsidiary is not taxable in France and France does not provide for any provision comparable to Subpart F of the U.S. Internal Revenue Code. There is no credit for foreign taxes paid unless a tax treaty so provides, but a French parent corporation is entitled to exclude 95 percent of the dividends reecived from a foreign subsidiary. In order to qualify for the exclusion, the French company must own at least 10 percent of the outstanding stock of the foreign corporation. Upon subsequent distribution to its stockholders, the French company might be liable for the precompte mobilier, which is a supplementary tax equal to 33⅓ percent of the gross amount of tax-exempt dividends received from foreign subsidiaries. But the corporation is free to determine whether the distribution is made out of previously taxed or untaxed earnings, and as long as taxed earnings exceed the amount of distrit 'ion to stockholders, the corporation may escape the supplementary tax. Moreover, shareholders are entitled to tax credits equal to 50 percent of the cash dividend.

2. Use of intercompany pricing rules to benefit exports.

Article 57, C.G.I. authorizes the French authorities to reallocate income between members of an affiliated group. With respect to exporting companies, the administration has officially stated that in dealing with French firms which have subsidiaries or branches abroad engaged in the export trade, it will not insist upon a strict application of such provision, "in order to permit the maximum development of exports and to aid in the establishment of enterprises intended to sell French products abroad." The statement provides further that companies which possess an exporter's card may sell to foreign affiliates at a price approaching its cost provided "the transaction is motivated by commercial necessity other than the desire to transfer profits abroad" (Note No. 893 of August 31, 1959, M.O.C.I. of September 26, 1959, Annex O). This statement raised strong protestations in the United States and the French Administration has issued a new Note in May 1973. Even though the exporter's card was abolished in 1973, there is no indication that the Administration has changed its policy of not strictly enforcing Article 57 against French companies engaged in exporting. In fact, the 1973 Note simply reiterates the position of not systematically applying Article 57 if commercial considerations rather than the transfer of profits can be proved to be the motivating factor. (B.O.G.D.I. 4A-2-73 dated May 4, 1973). Such an attitude is of fundamental significance. It converts the French basic tax structure with respect to taxation of foreign source income, into direct export incentives.

3. Specific tax export incentives.

(a) *Election to be taxed on a worldwide or consolidated basis.*—Upon authorization by the Ministry of Finance, French companies can elect to compute their French taxable income on a worldwide basis by adding together the profits and losses of their French and foreign branch activities. Another alternate election is to make a computation on a consolidated basis for all branches and subsidiaries, either domestic or foreign. Under each system, credit is given for foreign taxes with per-country limits of the French tax rate. The advantage of using either method is that losses from foreign operations can be used to eliminate otherwise taxable profits from French operations. This provision was enacted to put French oil companies on a par with the U.K. and U.S. oil companies. However, election of group taxation is not limited to oil companies.

(b) *Special reserves for losses of foreign businesses.*—In spite of the fact that profits of foreign branches or subsidiaries are not taxable in France, Article 39 octies A, C.G.I., as amended in December 1974, allows a French company which established a foreign sales, research or information office or subsidiary to constitute a special deductible reserve equal to:

(a) For activities established in the EEC countries, the lower of—

(i) losses (determined in accordance with French rules) incurred during the first five years of operations, or

(ii) the capital invested in said branch or company during the first five years.

(b) For activities established in other countries, with the exclusion of tax havens, the reserve can equal the amount of capital invested during the first five years.

For both (a) and (b), prior authorization must be sought from the Ministry of Finance but is deemed given if not refused within two months after the application was filed. It should be noted that these foreign situated activities must be of a nature that contributed to the sale of products manufactured in France (i.e., increase exports).

The reserve is gradually restored into taxable income starting the sixth taxable year following the first investment over a five-year period.

(c) Special reserves for investments in developing countries: French companies which establish industrial investments (e.g., manufacturing processing) in certain foreign countries, listed by the Ministry of Finance (basically developing countries) can, upon authorization from the Ministry of Finance, establish a reserve in deferral of French tax equal to a miximum of one-third of the capital invested during the first five years of operations or for investments made after January 1, 1975, the reserve can equal a maximum of one-half of invested capital.

All reserves are to be added back to taxable profits in the same way as mentioned above.

(d) Joint export programs: When small or medium sized businesses coordinate to make a joint effort to improve their businesses and set up a company for the purpose, they can negotiate a tax agreement with the Minister of Economy and Finance. This agreement gives them substantial tax and nontax advantages which vary from case to case. This program is made specifically applicable to joint export programs. The following advantages are currently available to an approved company:

Medium and long-term loan funds from public sources;

Rediscount facilities for drafts drawn by the shareholders upon the company;

The shareholders investment in the stock of the company is deductible in the year made;

The company, however, may depreciate its assets in the usual manner; and

Capital gains upon the sale of shares in the company may be reinvested without taxation within one year in shares of a similar company.

The company is not eligible to deduct its expenses for the establishment of a foreign office. It may however, obtain insurance from COFACE.

(e) Deductible provisions for banks: Banks and similar financing establishments which have granted loans to finance exports or foreign trade are allowed to constitute deductible provisions to cover the risks attached to these credits.

(f) Special reserves for export credit: Exporting companies which extend medium term credit are entitled to create a special deductible reserve to cover the risks inherent in the extension of credit abroad. Credit terms must be between two and five years. However, any extension of credit which is guaranteed by the government insurance corporation is entitled to this special deduction

regardless of its duration. The amount of the deductible reserve cannot exceed 10 percent of the credit and the amount deducted must be restored, but not until the final payment of the credit granted has been made. Such a provision allows a company to indefinitely defer a portion of its income, as long as it is engaged in the exporting business.

(g) Exclusion of exports from the "inflation levy": France introduced a new law, effective January 1, 1975, which is aimed at fighting inflation by penalizing business "margin" increases which are not the result of an increase in employment, exports or investments. The law imposes a temporary and refundable levy on the increase of a business enterprise's margin of a financial year over the preceding financial year's margin. The margin is the difference between purchases and sales (value added) in a given year, with certain adjustments. The rate of the levy is 33 and ⅓ percent. However, in order not to hurt export sales, the law excludes from the margin computation all transactions which are made in connection with exports. In other words, export income is excluded from the new inflation levy. The inflation levy provisions were extended to 1976.

4. Specific tax incentives indirectly benefiting exports.

A number of tax incentives are granted by the French government in order to promote industrial and regional development:

Exemption from local business tax up to a maximum of five years;

Reduction of registration tax from 16.60 percent to 4.8 percent in the case of purchase of a going business, and from 20 percent to 5.28 percent in the case of land; and

Accelerated depreciation of construction costs: 25 percent upon completion of the building.

These advantages are granted only to investments made in development areas. In order to promote industrial concentration, the government also allows losses of the absorbed or contributing company to be carried over by the surviving company. Moreover, if the dissolution of a company is found to improve the French economy, capital gains and reserves distributed upon liquidation are taxed at a fixed rate of 15 percent. These advantages are granted upon special authorization of the Ministry of Finance, and the practice shows that the existing or potential exporting activities of the applicant company generally induce a favorable decision.

II. NONTAX INCENTIVES

1. Specific nontax incentives

(a) *Export insurance programs.*—A government corporation created in 1948 (COFACE) provides French exporters with extensive insurance coverage. The credit guarantees covered by COFACE can be classified in 9 categories:

(1) Production risk: guarantees against sudden interruption of sales and resulting losses to the manufacturers of exporters prior to export.

(2) Credit risk: guarantees against the risk of nonpayment by the foreign purchaser once the goods have been exported.

(3) Accident risk: guarantees against damage to exported goods prior to their delivery.

(4) Commercial risk: guarantees against the insolvency of the foreign purchaser.

(5) Exchange risk: guarantees against currency fluctuation, devaluation and revaluation.

(6) Inflation risk: guarantees against cost increases of executing the contract. This coverage is not available for goods exported to E.E.C. countries.

(7) Market development risk: guarantees against expenses related to initial foreign operations including start-up expenses and the building up of inventory abroad.

(8) Exhibition expenses: guarantees participation in industrial fairs (excluding fairs held in E.E.C. countries) by covering expenses incurred, including rental and preparation of the stand, publicity costs, living and travel expenses of representatives and the cost of returning the goods exhibited to France.

(9) Political risk · guarantees against acts of foreign public authorities.

Short-term guarantees issued to COFACE are valid up to 180 days and are generally applicable to the sale of consumer goods. Light durable goods and merchandise delivered in a series can be covered up to 3 years.

Prior to March 1974, COFACE limited its short-term guarantees to countries where the political and commercial risks were not too high. Some of the countries excluded produced oil and raw materials. In order to promote French exports to

these previously excluded countries (e.g., Nigeria, Brasil, Indonesia), the Council of Ministers on March 20, 1974 decided that the French Treasury would assume the commercial risks, which means that COFACE now can insure French exports to these countries.

Medium and long-term COFACE guarantees for the manufacture of heavy durable goods, plant installations, and public works contracts are available but require special authorization from an inter-ministerial commission. Special contractual terms and conditions are required to be specified.

Coverage of the risks is 90 precent for political risks and 85 percent for commercial risks.

The market penetration risk insurance covers 50 to 70 percent of future losses from a market development effort during a period of three to five years. The exhibition expenses insurance provides for an immediate payment to a person showing its export products at an international fair equal to 80 percent of all expenses mentioned above. In these two types of insurance, the insured is required to repay the amounts received when profits exceed expenses. But he has had the advantage of that much additional working capital for the period.

(b) *Export financing.*—Credit to buyers and suppliers are generally used to support both medium and long-term export transactions. In France the government-related institutions dealing with export financing is the Banque Française du Commerce Exterieur. (BFCE)

In cooperation with French commercial banks, the BFCE limits its support to long-term credits. Medium-term suppliers' credits are supported by the Bank of France (Central Bank) by way of refinancing the early maturities thereof and by establishing interest rates for export financing in cooperation with French commercial banks and the BFCE. Such discount rates are usually below the market rates. The Bank of France discounts the early maturities of both medium-term export paper (18 months to 7 years) and the medium portions of longer-term export credits. Export credit insurance is a pre-requisite for refinancing.

The BFCE extends direct long-term loans on both a supplier and buyer basis. Exportation of all goods and services including capital goods are eligible for support. Generally up to 90 percent of the contract value is supported (100% in some cases). The interest rates charged borrowers for such long term export credits are generally 7.5 percent. The BFCE also provides for long-term "mixed loans" which are a combination of normal commercial terms with "soft terms" such as special long-term loans with extremely low interest rates. The portion of the long-term loans so subsidized varies from case to case.

(c) *Exporter's card.*—Although the "Exporter's Car[illegible]" was abolished by decree, March 27, 1973, it was expressly stated that the various advantages previously granted to cardholders were to be maintained.

A manufacturing company was usually entitled to an exporter's card if at least 20 percent of its gross sales consisted of exports, sales with France to nonresidents, royalties for the use outside of patents and know-how and certain advertising revenues. An exporter's card gave substantial advantages, such as market promotion and exhibition insurance coverage equal to 60 percent of the respective expenses for these activities (50 percent for other companies), duty free imports of export related goods up to an amount equal to 10 percent of the company's exports, and non-enforcement of the provisions under Article 57 of the C.G.I. relating to intercompany pricing rules.

2. Nontax incentives indirectly benefiting exports.

Investment incentives aimed at the development of depressed areas and at deconcentration of the Paris region, serve indirectly as an incentive to export to the extent that a company which is an important or potential exporter may obtain the incentives more easily. So far, this has been the usual administrative practice. The main advantages can be listed as follows:

(a) Industrial development and adaptation grants are available up to 25 percent of the investment in the case of the erection of new facilities and up to 20 percent in the case of conversion or extension of the facilities. The investment must exceed approximately $120,000 and create at least 30 employments or increase employment by 30 percent.

(b) Localization grants are available for companies establishing their headquarters outside Paris. The grant may amount from 15 to 20 percent of the investment made. It must create employment for at least 100 persons (50 in the case of research and development facilities).

(c) Decentralization indemnity: Enterprises moving their production facilities outside Paris are granted indemnities to cover moving expenses. The grant may

cover up to 60 percent of the total expenses. Employees of such enterprises are also granted reimbursement for their transportation and reinstallation expenses.

(d) Training subsidies: Subsidies may be granted for the training of unskilled labor and for in-plant training. It may consist of 60 percent of the salary of the instructors and of the trainees and 100 percent of the expenses of training the instructors.

Apart from incentives aimed at regional development, the government grants also additional incentives for economic development in general such as special loans at a low rate of 8 to 12 year duration for investments of special economic interest.

C. GERMANY

I. *Tax incentives*

1. Taxation of foreign source income.

(a) *Rules for direct exports:* A German company is taxed on its worldwide income. The income from a foreign permanent establishment is computed under German rules and added to the head company's income. The law provides for a foreign tax credit, but only to the extent of German rate on that same income. However, most tax treaties exempt profits of foreign branches from German taxes. Where this is the case, the German head office may, upon application, still deduct its foreign establishment's losses from its domestic income. The losses are first taken against any profits of other permanent establishments located in the same foreign country and then against domestic income. The unabsorbed balance of loss can be carried forward over a five year period. When sufficient profits are subsequently derived from the establishment(s) in the host country to offset the losses, the amount of losses deducted in Germany must be restored. This prevents a double deduction, but it does provide for an immediate tax benefit when a new permanent establishment incurs start-up losses.

(b) *Rules for exports through a subsidiary:* Income of a foreign subsidiary is not taxable in Germany. However, if a subsidiary is domiciled in a country with low taxation and is not active itself, the income of this subsidiary may be deemed to be income of the German parent company. Taxes paid by the subsidiary on this income may, upon application, be used as tax credit in Germany. This provision is somewhat equivalent to subpart F provisions under the U.S. Internal Revenue Code, although less stringent.

Dividends received from a foreign subsidiary are taxable to the parent company unless a tax treaty provides otherwise. Under most German tax treaties, Germany does not include in income dividends received from subsidiaries where the German parent owns 25 percent or more of the stock of the subsidiary. Where dividends are taxed, there is a credit for foreign taxes withheld at source. Except in the case mentioned above, no credit is granted for foreign taxes paid by the subsidiary on corporate income.

(c) *Reduced tax rates:* Where no tax treaty exists, however, foreign source income may still receive very favorable treatment. First, a German corporation is taxed at the rate of 51 percent but on its undistributed profits only. Profits which are intended for distribution to shareholders are taxed at the reduced rate of 15 percent. This provision applies to any type of income wherever derived from.

Moreover, under certain conditions the Federal Minister of Finance can grant complete or partial forgiveness of tax on the foreign source income of a resident taxpayer, or determine the tax on such income at a flat rate. The first condition is that the granting of either relief measure would be in the interest of the German economy as a whole. The second condition is that the application of the foreign tax credit would present unusual problems in an individual case.

Taxation at a flat rate (25 percent) applies to income from foreign unincorporated entities or from an investment in a foreign commercial entity located in nontax treaty countries. The entity must be exclusively or almost exclusively engaged in the production or delivery of merchandise abroad, the rendering of services abroad or the importing of merchandise from a foreign country into Germany. In the case of a foreign commercial entity, the investment must amount to 25 percent or more of the entity's share capital. Since the 25 percent tax rate is a substitute for the usual tax rate and foreign tax credit, the election for the flat tax rate becomes more advantageous as the foreign tax rate decreases. It is therefore an incentive for the establishment of sales companies or establishments in low tax countries. However, even though the income is distributed to shareholders, it cannot benefit from the reduced tax rate applied to distributed cor-

porate profits. On the other hand, losses incurred by these establishments whose income is taxed at the flat tax rate are fully deductible by the German head office. Although provisions exist in German law which penalize the establishment of subsidiaries in tax haven countries, the scope of their application is substantially limited by the fact that there are other means for German companies to have foreign source income taxed at low rates or not taxed at all.

(d) *Special provisions for deferral of taxable income:* Under restrictive conditions, a foreign subsidiary's losses may lead to a deferral of taxes on the parent's income. Upon acquisition or establishment of a corporation abroad, the German parent may constitute a deductible reserve for the loss of the subsidiary to be allocated to the percentage of shares owned, (but the amount of reserve can never exceed the book value of the initial investment). This reserve must be restored to income after five years or as soon as profits have made up the losses. The subsidiary must generally be 50 percent owned. A 25 percent ownership is permissible when the corporation is situated in a developing country. The foreign subsidiary must be either a manufacturer or distributor, or must be an agency or perform trade services. The same provision exists in French tax law but does not have the same purpose. The French provision was more especially directed at the establishment abroad of offices which would serve as antennas for developing the parent's exports. The German provision is aimed at boosting the establishment of foreign manufacturing concerns and capital exports but it obviously is advantageous to foreign based sales companies.

This provision is supplemented by tax deferral devices to encourage export of capital goods in exchange for an interest in a foreign company. The German parent is allowed to defer German corporate income tax on the profits realized on the transaction by creating a deductible reserve equal to the profit. The reserve is gradually dissolved after five years at a minimum rate of 20 percent over a period of five years. The reserve can only be created if the companies, partnerships, businesses or branches in the foreign country are engaged in one of the activities which qualify for concessions under the developing aid laws enacted in 1969, i.e., the production or sale of merchandise, the extraction of natural resources, commercial services or agriculture and forestry.

All these various tax provisions, which are primarily aimed at encouraging capital export and foreign direct investments, certainly provide substantial advantages as well to foreign sales companies.

2. Enforcement of intercompany pricing rules.

As opposed to other European countries, Germany has a policy of strict enforcement of the intercompany pricing rules, much similar to the U.S. tax authorities attitude. Intercompany pricing has always been an item to which the German tax auditors have paid particular attention. Where income of a foreign branch is exempt from German income tax by reason of a tax treaty, the authorities generally subject the intercompany transfer prices between the German company and its foreign branch to a detailed examination. It is known, however that this rule has been relaxed from time to time and that exports by German manufacturers at cost or at prices below cost have been approved in special situations. Apart from instances in which an overriding interest of the German economy as a whole was also involved, relaxation of the rules has sometimes been allowed in situations where a German company operated at less than capacity and production for a foreign subsidiary permitted full utilization of the parent's capacity.

3. Various tax incentives indirectly benefiting exports.

(a) Under the Berlin development law, a number of tax incentives are granted to encourage the economic development of this area:

Accelerated depreciation of up to 75 percent on depreciable fixed assets acquired for a Berlin branch;

Lower income and corporation profits tax rates on the profits of a Berlin branch; and

Special value added tax concessions on goods manufactured in Berlin and shipped to the Federal Republic. The Berlin manufacturing company is entitled to turnover tax preference of either 4.5 percent, 5 percent, or 6 percent of the invoice amounts of its shipments to West German purchasers. The West German purchaser is entitled on the other hand to a turnover tax preference of 4.2 percent of the income price of goods purchased from Berlin.

(b) Other special German laws grant various other tax incentives mainly intended for economic development of Eastern areas. The most significant of these

incentives is an accelerated depreciation of up to 30 percent for immovables and up to 50 percent of the cost of movable fixed assets that are used in businesses located at the East border of West Germany.

(c) Accelerated depreciation is also generally granted in respect to special fixed assets such as those used for sewage disposal, reduction of air pollution, certain mining equipment, research and development equipment. These incentives are not designed to promote export but it is clear that where incentives are granted, the benefits resulting therefrom are not restricted to domestic sales of a company's products. Export sales also benefit from these incentives.

II. Nontax incentives.

1. Specific nontax incentives directly benefiting exports.

(a) *Export guarantees through HERMES:* HERMES is a government-sponsored insurance company whose function is to guarantee exports by assuming part of the obligation for uncollectable receivables (commercial risks) or for the manufacturing cost of equipment if the goods ordered are not taken over by the foreign customer (production risks). As a rule, 10 to 20 percent of the risk must be borne by the foreign exporter. The institution also insures such other risks as rate of exchange fluctuations, inflation and political risks.

(b) *Export financing:* In the case of export receivables financing is psosible either with private banks or with a government-owned institution at preferential rates. Private banks purchase only such receivables which have not been guaranteed by HERMES. The financing of export transactions by a government-owned institution is available only in the case of exports to developing countries and export of ships. In such cases, long-term credits may be extended on both a supplier and buyer basis. The percentage of contract value supported generally varies from 70 to 80 percent for buyer credits and it is slightly lower for supplier credits. Like France and the U.K., Germany provides "mixed credits."

(c) *Technical assistance:* The German government provides assistance to exporters by making information available on the import requirements of individual foreign countries, import procedures, legal questions, customs duty rates, available financing, etc. In addition, a government agency exists to provide assistance to German firms participating in foreign trade fairs.

2. Nontax incentives indirectly benefiting exports.

Germany grants substantial economic development subsidies which may have a beneficial effect upon export trade. Most of these subsidies are in the form of cash grants allowed for economic development in selected areas. The cash grants are computed after a given percentage of the cost investment. The percentage ranges from 5 percent to 30 percent of the cost of the investment.

D. NETHERLANDS

I. Tax incentives

1. Foreign source income.

(a) *Rules for direct exports:* Although a Dutch corporation is taxed on its worldwide income, it is almost never taxed in practice on income derived from a foreign branch. To avoid double taxation on foreign source income, the Netherlands has concluded tax treaties with many countries, under which either foreign source income is exempt from tax by the source country or the foreign tax imposed reduces or eliminates the Dutch tax on the income by means of a tax credit.

Where relief is not provided by treaty, Netherlands law provides unilateral relief from double taxation on foreign source income from a foreign permanent establishment, provided the permanent establishment is subject to foreign income tax on said income. The Dutch tax is reduced by the amount which bears the same ratio to the Netherlands corporation tax liability on taxable income as the foreign source income bears to taxable income.

Example:

Foreign source income	Dfl. 100,000
Netherlands source income	Dfl. 700,000
Taxable income	Dfl. 800,000
Tax (48 percent of 800,000)	Dfl. 384,000
Exemption:	
Dfl. 100,000÷Dfl. 800,000×Dfl. 384,000	Dfl. 48,000
Final tax liability	Dfl. 336,000

If the foreign source income had not been taken into account, the final tax liability would have been the same as a result of the fixed corporate tax rate: 48

percent of 700,000=Dfl. 336,000. Moreover, while profits of a foreign branch are not subject to tax in the Netherlands, foreign losses are fully deductible from domestic profits. If any loss remains, it may be carried forward for six fiscal years, and set off against future foreign profits.

(b) *Rules for exports through subsidiaries:* Income of a foreign subsidiary is not subject to Dutch income tax. The Netherlands has no such provisions comparable to Subpart F of the U.S. Internal Revenue Code. The establishment of a sales subsidiary in a tax haven country is therefore not penalized. Dividends remitted to a Dutch company which is not an investment company are not taxable in the Netherlands provided that (i) the parent owns at least 5 percent of the issued capital of the foreign affiliate, (ii) that the equity participation is within the scope of the business activity of the parent and of the subsidiary, and (iii) that the foreign subsidiary is subject to foreign income tax.

Where dividends are taxable, foreign taxes withheld at source can be deducted from taxable income. Most Dutch tax treaties, however, provide for a direct foreign tax credit, in which case dividend income is reported as gross income.

2. Enforcement of intercompany pricing rules.

In general, the Netherlands tax authorities attempt to enforce the reallocation of income rules. However, Dutch companies may make an agreement on income allocation with the Tax Administration to cover a several year period and these agreements can be very favorable to the taxpayer.

There are no statutory rules against the allocation of profits between the head office and its foreign branch. The tax authorities have the power to require proper reallocation, although substantial discounts made to the branch by the head office may be possible provided they are made on an arm's length basis.

3. Specific tax incentives indirectly benefiting exports.

As a general rule, foreign source interest and royalties are subject to taxation in the Netherlands. However, many tax treaties concluded by the Netherlands provide for relief for foreign withholding taxes paid abroad. The Netherlands does allow special double taxation relief with respect to interest and royalties paid by residents in certain non-treaty developing countries. It is required that interest and royalties be subject to a tax on profit in the source country and that it be actually levied.

Also, a few tax incentives are granted for the purpose of economic development such as accelerated depreciation. Throughout the country (except in the provinces of Utrecht, South Holland and the main part of North Holland), one-half of the acquisition cost of business premises acquired after April 21, 1975 and before December 31, 1976 may be written down on an accelerated basis. The maximum rate allowed is 25 percent per annum and the depreciation must be spread equally over a period of two years.

In addition, an investment credit is available from 8 percent to 16 percent of the cost of certain capital assets to be spread equally over a period of two years.

II. Nontax incentives

1. Specific nontax incentives benefiting exports

(a) *Customs duties.*—No import duties are due on goods which are temporarily imported into the Netherlands for repairing, processing or assembling and reexported thereafter. Similarly, no duties are due where goods are temporarily exported for repairing, processing, assembly and reimported within one year after the exportation. Duties are levied only on the incremental value of the goods imported.

(b) *Export financing.*—Commercial paper obtained in export transactions can be discounted or pledged at favorable rates at commercial banks, under the guarantee of the Central Bank. Moreover, the Export Financing Company partly finances medium and long-term export credit, at rates usually below the market rate (usually 9.5%).

(c) *Credit insurance.*— Almost all risks in connection with export transactions may be insured with a special credit private institution which has special arrangements with the government. Coverage is generally 75 percent, but a maximum of 100 percent is possible. Exchange rate fluctuation risks may be covered up to 95 percent.

2. Specific nontax incentives indirectly benefiting exports.

Aid to economic development is granted also by way of nontax advantages. Such incentives, however, do have a favorable effect on export trade activities as well, to the extent that over one-half of the gross national product is currently exported.

(a) *Investment premiums.*—In the development areas, a subsidy of 25 percent of the aggregate investments in fixed assets (lands, buildings, machinery) may be granted. The subsidy cannot exceed approximately $1.1 million (Dfl. 3,000,000) and some requirements must be met such as:

A minimum investment of approximately $150,000 (Dfl. 400,000);

Equity (capital plus reserves) after investment less premiums amount to at least 40 percent of the total invested capital.

The premium may, at the election of the enterprise, be paid in a lump sum or in five installments.

(b) *Investment premiums for extension of industrial enterprises.*—Extensions of industrial enterprises, located in certain stimulation areas, are eligible for a premium composed of two parts: a lump sum of 15 pereent of the cost of investment in tangible capital assets and an amount of approximately $2,000 (Dfl. 5,000) for each additional permanent job created. The aggregate premium cannot exceed the lesser of either 25 percent of the cost of investment or $1.1 million (Dfl. 3,000,000). The principal condition for the grant of extension premiums is substantially identical to that for investment premiums.

(c) *Interest subsidies for the establishment of new industrial enterprises.*—Interest subsidies may be granted in connection with projects of exceptional importance for the strengthening of the industrial structure of the southern and northern development areas. The maximum subsidy is 3 percent over a period of not more than 15 years and may be available for medium-term and long-term capital loans from commercial banks. Although formally still in existence, the interest subsidy has never been granted in practice.

E. JAPAN

I. Tax incentive

1. Taxation of foreign source income.

Japanese companies are taxed on a worldwide basis under rules which are much similar to those in effect in the United States. Such tax system will not therefore, be described in detail but only the relevant variances from the U.S. tax system will be mentioned.

(a) Japanese tax law has no provision comparable to Subpart F of the U.S. Internal Revenue Code.

(b) The allowable foreign tax credit is computed on the overall basis. For purposes of computing the limitation, any loss incurred by a foreign branch need not reduce other foreign source income. This provision is referred to as the "modified overall limitation and is available upon application to the tax authorities.

(c) Japan imposes an excise tax (so-called "commodity tax") on manufacturers importers or retailers on the sale of 17 types of commodities. Food, medicines and other essential consumer goods and food products are outside the scope of the tax. The tax ranges from 5 percent (for beverages and motor vehicles with two or three wheels) to 30 percent (mainly for luxury items). Commodities exported are exempt from the tax. If the product is exported after being taxed, the tax is repaid and there are special provisions authorizing an exemption or repayment for component parts of exported products. Imports are taxed at the same rate as similar goods on the home markets.

2. Tax incentives directly benefiting exports.

Like any other country in Europe, Japan has been somewhat concerned about encouraging exports. Because its basic tax structure does not allow such effect, it has traditionally provided for driect export tax incentives.

(a) *Reserve for overseas market development.*—Corporations deriving income from overseas transactions are entitled to deduct limited amounts credited to a reserve for overseas market development. These transactions include export of goods, sale of goods to an exporter and processing of goods to be exported, provided payment is in foreign currency. The deductions may go from 1.0 percent to 1.7 percent of the export value of goods purchased from others, depending on the amount of the corporation's capital and may go from 1.5 percent to 2.3 percent for all other overseas transactions. One-fifth of the amount credited to the reserve must be returned each year to income in the five years immediately following the creditation.

(b) *Deduction of overseas investment losses.*—Corporations acquiring and holding 10 percent or more of particular shares of a "Specified Overseas Enterprise Juridical Person", or 1 percent or more of particular shares of a "Specified Investment Juridical Person", can deduct amounts credited to a reserve for

losses from such investments up to a specified ratio of the acquisition cost of the shares. A "Specified Overseas Enterprise Jurisdical Person" is a corporation or other legal entity whose head office is located outside Japan for purposes other than avoidance of taxes and which conducts any kind of business except the investment business. A "Specified Overseas Investment Juridical Person" is a domestic corporation that mainly invests in, or makes long term loans to, a specified overseas enterprise juridical person. These juridical persons are specified where their head office is located in a specified statutory geographical area, mainly developing areas or where they deal with such jurisdical persons.

Amounts deducted must be added back to taxable income over a five-year period commencing five years after the current taxable year of the deduction.

(c) *Foreign exchange losses.*—A domestic corporation can establish a deductible reserve for foreign exchange losses on its net long term receivables. Amounts deducted must be added back to taxable income in the next accounting period.

(d) *Entertainment expenses related to export activities.*—There is generally a severe limitation on the deductibility of entertainment expenses for tax purposes in Japan. Ordinarily a deduction is limited to about $13,333 per corporation plus ¼ of 1 percent of capital. The deduction for entertainment expenses in excess of this is limited to 25 percent of the expenditure. However, until 1971, a reasonable amount of overseas and/or domestic travel and hotel expenses in Japan paid for nonresident visitors and entertainment expenses incurred abroad in connection with export transactions were not treated as entertainment expenses for purposes of determining the deductible amount of entertainment expenses, and were fully deductible for corporate income tax purposes.

(e) *Export allowance.*—Domestic corporations are allowed substantial special deductions for certain overseas transactions in an accounting period beginning on or before March 31, 1976. The deduction is the lesser of an amount computed by applying a percentage to proceeds or to net income. The eligible transactions are as follows, provided payment is in a foreign currency:

Sales or licensing of industrial property rights and the furnishing of technical knowledge such as know-how. The amounts deductible are 70 percent of the proceeds from the transaction limited to 50 percent of the total ordinary income.

Sales of copyrights. The amounts deductible are 30 percent of the proceeds from the transactions also with a 50 percent limit.

Consulting or rendering technical services such as research and planning with respect to the manufacture or construction of production facilities, or technical guidance regarding agriculture and fishing. The amounts deductible are 20 percent of the proceeds from the transaction also with a 50 percent limit.

(f) *Accelerated depreciation in case of export sales.*—In 1961, Japan enacted a law to provide for accelerated depreciation in case of export sales. This provision was repealed in 1972 because its objectives were no longer viable in that, while it was originally enacted as a means of stimulating exports by providing tax relief, beginning in 1969 Japan started experiencing an unfavorable international balance of payments because of greatly increasing exports.

Under this law, a corporation was allowed a tax deduction for accelerated depreciation based on export sales made in the immediately preceding year. The amount of additional depreciation was computed by applying the ratio of export sales over total sales to maximum ordinary depreciation available. In other words, ordinary depreciation was increased by 24 percent. Ordinary depreciation was at generous rates in the first place. Additional increases in depreciation could be allowed depending on the incremental amount of export sales in each year.

II. Nontax incentives

1. *Export financing:*

(a) Japanese suppliers can receive medium and long term credits from the Export-Import Bank of Japan, a government related agency. Generally, medium term sales are supported by means of direct loans at preferential rates of interest. Medium term credits are not supported in Japan.

(b) Long term credits are available from Eximbank both on a buyer and supplier basis. Long term credits are those credits exceeding five years. Eximbank usually supports 48 to 64 percent of the contract value and the rates charged as of December 1974 ranged from 7.75 to 8.75 percent. These rates include all types of financing charges but not insurance cost.

2. *Export insurance:*

(a) Export insurance is granted in Japan by the Export Insurance Division/ Ministry of International Trade and Industry (MITI). MITI offers export bill

insurance to Japanese foreign exchange banks that have purchased eligible debt obligations from exporters. This Japanese Bank guarantee is available for consumer goods exports only.

(b) Moreover, a variety of risks are covered such as insolvency of the buyer, protracted default, currency inconvertibility, exchange rate fluctuations, loss of foreign investment, and political risks. Commercial risks are usually covered from 60 to 80 percent while political risks are usually 90 percent covered.

F. UNITED KINGDOM

I. Tax incentives

1. Taxation of foreign source income.

(a) *Rules for direct exports.*—A British corporation is taxed on its worldwide income provided it is a resident company. Residency is determined in accordance with the place of management and control and not the place of legal incorporation. Because such a system could give way to substantial tax evasion by exporting the control of a U.K. corporation into a foreign country, a resident corporation must apply for permission to move its corporate residence outside the U.K., and it is usually difficult to obtain such consent. But the fact remains that a number of U.K. companies are not subject to U.K. taxes because they are fully managed and controlled from outside the U.K.

A British resident corporation is taxed on income derived from foreign establishments whether or not the profits are remitted to the U.K. head office. However, foreign tax credit provisions cause no U.K. corporation tax to be payable on foreign source income as long as the rate of taxes paid abroad is below or equals the U.K. tax rate on that same type of income.

The effectiveness of this double tax relief provision was somewhat reduced by the enactment in 1972 of the "Advance Corporation Tax" which became effective from April 1, 1973. The general rule is that where a company makes a qualifying distribution to its shareholders, the company becomes liable for a tax payment equal to 35/65 of the sum distributed. The ACT is then deductible from the corporation tax liability of the company on its profits for that accounting period (termed "mainstream corporation tax"). The new system was mainly introduced for purpose of administrative simplification and avoidance of coroprate income double taxation. However, the liability for ACT is not reduced by the foreign tax credit. That limits the foreign tax credit to the corporate tax liability in excess of the ACT. As a consequence, a portion of the foreign tax credit may be disallowed if dividends are paid out of foreign source income, and this is a substantial disadvantage for U.K. companies deriving most of their income from foreign operations. Some relief has been allowed, however, by way of the so-called "overspill relief" which was extended until 1976. Moreover, any company may exercise the option so as to set off ACT against liability to mainstream corporation tax on domestic income before overseas income and against liability to mainstream corporation tax on overseas income taxed on lower rates before higher rates.

(b) *Rules for export through a foreign subsidiary.*—Income of a nonresident corporation is not taxable in the U.K. Moreover, there are no provisions in U.K. tax law comparable to subpart F of the U.S. Internal Revenue Code. Foreign source dividends are taxable to the U.K. parent company, but the resident company is allowed a deemed paid foreign tax credit, whose terms are more favorable than its U.S. counterpart. The deemed paid tax credit is allowed to companies receiving dividends from foreign firms that are at least 10 percent controlled, directly or indirectly. However, the indirect credit is permitted for holdings of less than 10 percent where there has been a reduction after 1972 for reasons that could not be prevented. It appears that the taxpayer can designate the period of profits out of which a dividend is paid and thereby affect the amount of creditable taxes. A per-country limitation applies to the foreign tax credit but such limitation can be moderated or avoided in a number of ways.

2. Enforcement of intercompany pricing rules.

To the extent that income of a nonresident company is not taxed in the U.K. until distributed by way of dividends even though use is made of tax haven countries, the tax advantages of establishing a foreign based sales company depends upon how the intercompany pricing rules are enforced.

The experience so far has been that it is unusual for adjustments to be proposed by the tax authorities. One of the reasons might be that such adjustments are generally unnecessary for the companies that are usually most subject

to enforcement. As already mentioned, the incorporation abroad of an export trade requires the Administration's authorization. When a tax haven is involved, the U.K. company might have to give assurances that prices will be at arm's length in order to obtain the authorizations. Therefore, very few adjustments are probably required in such a situation.

A second reason is also that such adjustments are generally settled rather than litigated. And the experience has proved that a U.K. company may show that the activities of a foreign sales subsidiary will increase exports from the United Kingdom. Such assertions are known to have considerable influence on the attitude of the authorities toward low prices for exports to selected companies.

3. Specific tax incentives indirectly benefiting exports.

The United Kingdom allows only one minor direct export tax incentive, namely the deduction of business entertainment expenses for corporation tax purposes, but only if the customer entertained resides overseas and is carrying on a trade or business. On the other hand, highly favorable rates of depreciation are granted in connection with a general program of stimulating capital formation.

Investment incentives include the privilege of writing off in one year the whole cost incurred for plant, machinery and equipment. This is known as the "first year allowance". If the first year allowance is only partly used, a high annual depreciation rate (25 percent) is allowed on the same items. Since 1974, the initial depreciation rate on the construction of industrial buildings has been 50 percent of the cost thereof (it was 40 percent before 1974), with an annual writing down of 4 percent.

II. Nontax incentives.

1. Export nontax incentives.

(a) *Export financing.*—Support to export financing is available through the Export Credits Guarantee Department (ECGD). The ECGD does not extend export credits directly. British clearing banks provide such credits in exchange for ECGD unconditional repayment guarantees, interest rate subsidies and limited portfolio refinancing. The support applies to both medium and long-term credits both on a supplier and buyer basis. Through its guarantee and interest rate subsidies, the ECGD supports from 80 to 100 percent of long-term contract value. The average rate charged borrowers for long-term export credit is approximately 7.8 percent including finance charges but not insurance costs.

(b) *Export credit insurance.*—Export credit insurance is available through the same agency, ECGD. It covers both commercial currency fluctuations and political risks. The percentage of debt normally insured is 90 for buyer risks and 90 or 95 for political and economic risks. ECGD has very recently introduced a still unique type of insurance, mainly the coverage of risks due to inflation.

Inflation risks are covered for capital goods contracts with an individual value of L2 million or more with manufacturing periods of two years or more. The exporters or buyers are required to bear the first 10 percent of cost increase and thereafter the ECGD will cover 90 percent of the next 15 percent of annual cost increase on a cash contract and 85 percent of the next 10 percent of cost increase on a credit contract. The premium charged is 1 percent per annum of manufacturing period on the eligible value. The program is due to end early in 1977 but will be reviewed in the light of the circumstances then prevailing. It is available for exports to any country except to the EEC countries.

Also where foreign buyers insist on performance bonds, the ECGD usually makes its support available, applying normal standards of underwriting judgment where bonds cannot otherwise be raised. The contracts must be cash or near cash contracts with a minimum U.K. content value of L20 million.

(c) *Technical assistance to exporters.*—There are a large number of subsidized services available to exporters through the Department of Trade and Industry (DTI). DTI arranges for the collective participation of British exporters to the trade fairs and exhibitions, provides for information and advertising and works out programs intended to promote British goods.

2. Nontax incentives indirectly benefiting exports.

(a) *Regional development.*—In connection with a program of industrial and regional development, the British Government makes available a number of cash grants, the amount and terms of which depend upon the designated assisted area.

Special development area.

Regional development grants of 22 percent are available towards the cost of capital expenditures on certain new plant and machinery and on industrial buildings. These grants are not deductible in calculating the value of expenditures for the purpose of taxation allowances.

Factories built by the Department of Trade and Industry may be leased at favorable rentals, in some cases with an initial rent-free period. Loans on favorable terms may be made available in selected cases where additional employment is provided, an alternative being interest subsidies granted on commercial loans.

Removal grants may be obtained for up to 80% of certain costs involved in moving an undertaking into one of the assisted areas.

Assistance can be obtained from the Department of Employment toward the cost of training additional labor and of transforming workers in connection with establishing new enterprises.

Employers receive regional employment premiums at the weekly rate of £3 per male worker and £1.50 per female worker.

Development areas

The regional grants are payable at the rate of 20%. Factory rentals, loans, interest subsidies, removal and training grants and regional employment premiums are the same as for Special Development Areas.

Intermediate areas

Regional buildings grants are available at 20 percent on the cost of industrial buildings. There is no regional grant on purchases of plant and machinery. Other incentives are similar to those mentioned above, except that employers do not receive regional employment premiums.

(b) *Industrial development.*—Under the Industry Act 1972 as amended by the Industry Act 1975, government assistance is available on certain new investments which meet the following conditions:

It must be a new investment of modernization the capital cost and working capital of which exceed £500,000.

It must be a net addition to the company's capital investment, i.e., it would not take place or would be deferred but for government assistance;

The project must be commercially sound and lead to improvements in the balance of payments; and

The construction work on the project must commence before 30 September 1976.

The government support will be the minimum considered necessary and will consist of loans at concessionary rates of interest but in appropriate cases could be interest free. The support could also be in the form of an interest relief grant.

In order to encourage employers to retain employees who would otherwise be made redundant a temporary employment subsidy may be paid. The subsidy is £10 per week for each deferred redundancy of full time workers and is applicable where redundancies affect 50 or more workers.

Appendix D

TAX INCENTIVES FOR EXPORTS

	Austria	Portugal	Australia	New Zealand	Japan	Canada
Taxation of foreign branch income.	Fully taxed at usual rate (progressive rates from 30 percent to 55 percent). Deduction for foreign taxes paid. Foreign tax credit upon application.	Exemption of ⅔ of income (effective tax rate of 17.4 percent).	Exempt except if has not been taxed abroad (tax rates from 47.5 to 50 percent).	Fully taxed at usual rate (tax rates are from 20 to 45 percent). Foreign tax credit.	Taxable at usual rate (effective tax rate of 52 percent). Favorable foreign tax credit system.	Fully taxable at usual rate (46 percent). Foreign tax credit.
Taxation of foreign subsidiaries.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	Yes, but under conditions less stringent than under subpt. F income.
Deductibility of foreign branch losses.	Fully deductible	Fully deductible	Fully deductible	Fully deductible	Fully deductible	Fully deductible.
Taxation of foreign source dividends.	Exempt if at least 25 percent control.	Exempt if at least 25 percent control. ⅓ taxable in other cases.	Exempt in practice	Exempt	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Exempt when foreign subsidiary is controlled (50 percent). Partial exemption from 1976. Foreign tax credit.
Special deferrals of taxable domestic income.	Investment reserves	None		None	Income may be deferred for overseas market development, overseas investment losses, foreign exchange losses.	None.
Specific export tax incentives.	10 percent writeoff with respect to acquisition of shares in certain foreign entities. Custom-free zones.	do.	Deductions and rebates for export market development expenses.	Deduction of 150 percent of the cost of export-related expenditures. Deduction of an amount related to increased export sales.	Reserves for overseas market development. Deduction of overseas investments. Reserves for foreign exchange losses. Special deductions for certain overseas transactions.	Do.
Intercompany pricing rules					Favorable treatment for exporting companies.	
Border tax adjustments (VAT).	VAT (rate 16 percent) zero rate on exports.	None	None	None	None	Do.
Tax incentives indirectly benefiting exports.	Accelerated depreciation or tax-exempt investment reserve.[1]	Reduced tax rate or exemption from taxation for introduction of new products or processes. Accelerated depreciation.	do.		do.	Tax reduction for manufacturing income. Accelerated depreciation.[1] Investment tax credit.

	Belgium	France	Germany	Italy	Luxembourg	Netherlands
Taxation of foreign branch income.	½ the usual rate (40 percent).	Exempt[3] (corporate tax rate is 50 percent).	Normal tax rate (51 percent plus foreign tax credit or, in certain cases, imposition of a flat 25 percent tax rate.	Taxed at usual rate (35 percent). Foreign tax credit.	Exemption on 50 percent of income (progressive tax rate from 20 to 40 percent. Foreign taxes deductible.	Taxed at usual rate. Favorable foreign tax credit system.
Taxation of foreign subsidiaries.	None. No subpt. F income equivalent.	None except if election is made. No subpt. F income equivalent.	Yes, but under conditions less stringent than the U.S. subpt. F provision.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.
Deductibility of foreign branch losses.	Fully deductible even though foreign income is exempt under tax treaty.	Note deductible[3]	Fully deductible even though foreign income is exempt under tax treaty.[4]	Fully deductible		Fully deductible.
Taxation of foreign source dividends.	Permanent participation held for more than 1 year): 95 percent exclusion plus 5 percent tax credit. Nonpermanent participation: 15 percent tax credit.	95 percent exclusion if French company owns 10 percent or more of the stock.	Fully taxed at usual rate. Foreign tax credit and deemed paid foreign tax credit under certain circumstances.	Fully taxed at usual rate. Foreign tax credit.	50 percent exclusion if at least 25 percent control. Total exemption for holding companies Foreign taxes deductible.	Exempt in majority of cases.
Special deferrals of taxable domestic income.	None.	Income may be deferred for losses of certain foreign business, cost of investment in certain business in LDC's, export credit extended to foreign buyer.	Income may be deferred for losses of foreign branches whose income is tax exempt, losses of foreign subsidiaries, profits realized upon an exchange of property for stock of a foreign corporation.			None.
Specific export tax incentives.	do.	Joint export programs, election to compute income on a worldwide basis, all special deferrals, exclusion from the inflation levy.	None.		do.	Tax credit for withholding tax on interest and royalties paid by residents in certain nontreaty LDC's.
Intercompany pricing rules.	Will provide assurances on allocation in certain cases. Historically generous to exporters.	As a general rule, not enforced against exporters.	Usually enforced although relaxation may be granted in special circumstances.			Usually enforced but special agreement used. May be negotiated with the tax authorities.
Border tax adjustments (VAT).	VAT (18 percent rate) up to 25 percent for luxury items. Zero rate on exports.	VAT (20 percent rate) up to 33 percent for luxury items. Zero rate on exports.	VAT (11 percent rate). Zero rate on exports.	VAT (12 percent up to 30 percent for luxury items). Zero rate on exports.	VAT (rate 10 percent). Zero rate on exports.	VAT (16 percent rate). Zero rate on exports.
Tax incentives indirectly benefiting exports.	Accelerated depreciation, exemption from real estate tax, reduced income tax rate on certain reinvested profits.[5]	Accelerated depreciation, exemption from local business tax, reduction of registration taxes.[5]	Accelerated depreciation, reduction of corporate tax rate and VAT rates.[5]	Tax exemption or reduction for financial or Government-owned companies.[5]	Investment credit from 3 to 9 percent of cost of certain capital assets.	Accelerated depreciation.[5] Investment tax credit from 8 to 16 percent of cost of certain capital assets.

	United Kingdom	Ireland	Denmark	Norway	Sweden	United States
Taxation of foreign branch income.	Taxable at usual rate (52 percent. Foreign tax credit.	Taxable at usual rate. (Average rate 50 percent). Deduction for foreign taxes paid.	Taxed at half the usual rate (½ of 37 percent). Foreign tax credit.	Exemptions on 50 percent of income (rate is 26.5 percent).'	Taxed at usual rate (effective income tax rate is 54 percent). Foreign tax credit.	Fully taxable at usual rate (48 percent). Foreign tax credit.
Taxation of foreign subsidiaries.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	None. No subpt. F income equivalent.	Yes, under subpt. F provisions.
Deductibility of foreign branch losses.	Fully deductible. Deductible against foreign source business income only when carried over to following years.	Fully deductible	Fully deductible		Fully deductible	Fully deductible.
Taxation of foreign source dividends.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Fully taxed at usual rate	Fully taxed at usual rate. Deemed paid foreign tax credit.	Half exempt if at least 95 percent control.	Fully taxed at usual rate. Foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.
Special deferrals of taxable domestic income.	None		None	Tax-free reserves deductible		About 25 percent of taxable income may be deferred under the DISC provisions.
Specific export tax incentives.	Deduction of business entertainment expenses connected with export activities.	Exemption from corporate taxes on profits attributable to exports of goods produced in Ireland.		do	Additional deduction for interest charged on export credit.	None, aside from DISC.
Intercompany pricing rules.	Not actively used				Not actively used	Strictly enforced, including against export industry. Important cases against exporters pending.
Border tax adjustments (VAT).	VAT (8 percent rate up to 25 percent for luxury items). Zero rate on exports.	VAT (19.5 percent up to 36.5 percent for luxury items). Zero rate on exports.	VAT (15 percent rate). Zero rate on exports.	VAT (20 percent rate). Zero rate on exports.	None	None at Federal level.
Tax incentives indirectly benefiting exports.	Favorable rates of depreciation.[1]	Accelerated depreciation.[1]	Tax-free investment reserves constituted by 20 percent of annual profits. Dissolved after 10 yr.[1]	Accelerated depreciation. Tax-free reserves deductible.[1]	Accelerated depreciation.[1]	Accelerate depreciation. Investment tax credit (10 percent).

[1] Most of the tax incentives are granted in connection with industrial and regional development.

[2] Foreign branch income is taxable at usual rate if the French company elects to be taxed on a worldwide or consolidated basis.

[3] Losses of foreign branches are deductible when the domestic company elects to be taxed on a worldwide or consolidated basis.

[4] When the income has not been taxed abroad, the amount deducted for foreign losses must be put back into income after a number of years.

[5] Most of the tax incentives are granted in connection with industrial and regional development.

NONTAX INCENTIVES FOR EXPORTS

	Austria	Portugal	Australia	New Zealand	Japan	Canada
Nontax incentives indirectly benefiting exports.	Investment allowances[1]		None			Cash grants.[1]
Financing assistance	Guarantees for medium-term credits. Rate of interest is 7 percent.				Direct loans for medium-term sales. Long-term credits at preferential rates (from 7.5 percent to 8.75 percent). Financing of contract value from 48 percent to 64 percent. Mixed credits.	
Insurance assistance					Are insured: Production risks, commercial risks, political risks, currency fluctuations, loss of foreign investment. Risks are covered from 60 percent to 80 percent.	

[1] Most of the nontax incentives are granted in connection with industrial and regional development.

NONTAX INCENTIVES FOR EXPORTS

	Belgium	France	Germany	Italy	Luxembourg	Netherlands
Nontax incentives indirectly *benefiting* exports.	Interest subsidies. Investment subsidies.[1]	Grants. Investment subsidies.[1]	Grants[1]	Capital grants. Long and medium term loans by specialized Government institutions.[2]	Grants. Loans. Guarantees[1].	Investment subsidies. Interest subsidies.[1]
Financing assistance	Discount at low rates. Interest rebates on export credit. Subsidized medium term export financing. Average rate borne by exporters is 9 percent. Financing of up to 90 percent of contract value.	Discount at low rates. Long-term loans at 7.5 percent rate, to both suppliers or buyers. Financing of up to 100 percent of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Preferential rates of 10 percent. Financing of up to 80 percent of contract value. Mixed credits.	Discount at low rates. Interest subsidies. Long-term loans at 8.95 percent rate to both suppliers and buyers. Financing of up to 100 percent of contract value.		Discount at low rates. Guarantees. Subsidized medium and long term export credits. Average interest rate borne by exporters is 9.5 percent. Financing of up to 90 percent of contract value.
Insurance assistance	Are insured: Commercial risks, political risks, currency fluctuations. Risks covered from [illegible] percent to 100 percent.	Are insured: Production risks, commercial risks, political risks, currency fluctuations, market development, exhibition expenses, inflation risks. Risks are covered from 80 percent to 100 percent.	Are insured Production risks, commercial risks, political risks, currency fluctuations, inflation risks. Risks are covered from 80 percent to 100 percent.	Are insured: Commercial risks, political risks, currency fluctuations, inflation risks. Risks are 90 percent covered.		Are insured: Commercial risks, political risks, currency fluctuations. Insurance usually covers from 75 percent to 100 percent of the risks.

[1] Most of the nontax incentives are granted in connection with industrial and regional development. In Belgium, interest subsidies are granted for the purpose of investment throughout the country and not only in depressed areas.

NONTAX INCENTIVES FOR EXPORTS

	United Kingdom	Ireland	Denmark	Norway	Sweden	United States
Nontax incentives indirectly benefiting exports.	Grants. Investment subsidies. Interest subsidies.[1] Employment subsidies.[2]	Investment allowances. Training grants. Loan guarantees.[1]	Loans. Cash grants [1]	…	Investment allowances. Loan guarantees.[1]	None, except limited agricultural subsidies.
Financing assistance	Guarantees. Interest rate subsidies. Portfolio refinancing. Support granted on a supplier and buyer basis. Interest rate borne by borrowers: 7.8 percent. Financing of up to 100 percent of contract value. Mixed credits.	Guarantees. Medium-term loans at preferential rate: (8 percent). Financing of up to 80 percent of contract value.	Guarantees. Financing of up to 90 percent of contract value. Interest rate is 8.5 percent after first year.	…	Medium and long-term financing at 2 percent or 3 percent above discount rate. Financing of up to 100 percent of contract value.	Discount at medium rates. Guarantees. Long-term export credit financing at interest rates from 8.25 percent to 9.5 percent. No mixed credits. Financing of 30 percent to 55 percent of contract value.
Insurance assistance	Are insured: Commercial risks, political risks, production risks, inflation risks, currency fluctuaions, performance bonds. Risks are covered up to 100 percent.	Are insured: Production risks, commercial risks, political risks, currency fluctuations. Risks are covered up to 100 percent.	Are insured: Commercial risks, political risks, currency fluctuations. Risks are covered from 65 percent to 90 percent.	…	Are insured: Commercial risks, political risks, currency fluctuations, inflation risks. Risks are covered up to 90 percent.	Are insured: Commercial risks, exhibition expenses, political risks. Risks are covered up to 95 percent.

[1] Most of the nontax incentives are granted in connection with industrial and regional development.
[2] Granted in order to encourage employers to retain employees.

TAX INCENTIVES FOR EXPORTS

[X indicates country has incentives; NA indicates that information not available]

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	United Kingdom	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	United States
Partial or total exemption on foreign branch income.	X	X	X		X				X	X		X		X	X				
Foreign subsidiaries not subject to tax.	X	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X		
Foreign branch losses deductible.	X		X	X	NA	X	X	X	X	NA	X		NA	NA	X	NA	X	X	X
Partial or total exemption on foreign source dividends.	X	X			X	X			X			X	X	X	X	X		X	
Special deferrals of domestic income.		X	X	NA				NA		X	NA				NA		X		X
Export tax incentives		X				X	X	X	NA	X	X		X		X	X	X		(1)
Nonenforcement of intercompany pricing rules.	X	X		NA	NA	X	X	NA	NA	NA	X	NA	NA	NA	NA	NA	X		
Border tax adjustments	X	X	X	X	X	X	X	X	X	X			X						

1 DISC only.

NONTAX INCENTIVES FOR EXPORTS

[X indicates country has incentives; NA indicates that information not available]

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	United Kingdom	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	United States
Nontax incentives indirectly benefiting exports	X	X	X	X	X	X	X	X	X	NA	X		X	NA		NA	NA	X	
Financing assistance														NA	NA	NA		NA	
Rate of interest (percent)	9	7.5	10	8.95	NA	9.5	7.8	8	8.5	NA	(1)	NA	7				7.5–8.7		8.25–9.5
Portion of contract value financed (percent)	90	100	80	85	NA	90	100	80	90	NA	100	NA	NA				48–64		[2] 30–55
Mixed credits		X	X														X		
Insurance assistance					NA					NA		NA	NA	NA	NA	NA		NA	
Commercial risks	X	X	X	X		X	X	X	X		X						X		X
Political risks	X	X	X	X		X	X	X	X		X						X		X
Production risks		X	X				X	X									X		
Currency fluctuations	X	X	X	X		X	X	X			X						X		
Performance bonds							X												
Market developments		X																	
Exhibition expenses		X																	X
Inflation risks		X	X	X			X				X								

[1] 2 or 3 percent above discount rate

[2] To buyers.

Appendix E

The Nature and Effect of the 1976 GATT Panel Decisions on DISC and Foreign Tax Practices

I. The GATT Complaints

The current confrontation over direct-tax export subsidies originated with a complaint against DISC brought under GATT procedures by the European Community. The United States responded with counter-complaints against certain direct-tax export subsidies of France, Belgium, and the Netherlands. A special GATT Panel which had been convened to study the dispute last fall found *prima facie* cases that the practices of all four countries infringed the GATT rules. The European Community's categorical rejection of the Panel's findings as to the three European countries has produced an impasse between the U.S. and Europe which seems likely to continue until the European nations agree to discussions on the export subsidy issues.

The nature of the arguments in this dispute—and especially the positions taken by the European Community—provide an unusual insight into the nature of the export subsidy problem and the deficiencies of the current international rules on the subject. Accordingly, this section will analyze that dispute in some detail. At the outset, however, it may be useful briefly to summarize the relevant GATT procedures for the resolution of such disputes.

A. *The GATT Procedures.*—GATT does not contain a formal judicial procedure for the settlement of disputes; such provisions (including ultimate appeal to the International Court of Justice) were dropped from the early drafts. Instead, Article XXIII of GATT offers a pragmatic method of settling disputes by means of consultations and review, designed not to lock the parties into inflexible positions. The DISC proceedings, which have been going on for more than five years, are a good example of how current GATT procedures seek to aid the parties to resolve their disagreements by discussion rather than by judicial fiat. Under present GATT procedures, in fact, it is virtually impossible for a final decision to be reached and sanctions authorized without an agreement or consensus being reached among the parties directly involved.

Article XXIII:1 provides, in essence, that a party feeling in some way injured should make written proposals or representations to other parties involved, which are to consider them "sympathetically." Thus the present proceedings began in October, 1971 with the filing of a protest note by the European Community. A request for consultations in February, 1972 was followed by a series of 23 consultative sessions between the United States and the European Community.

Where no agreement is reached in the initial consultations, the dispute is then referred, under Article XXIII:2, to the GATT Contractnig Parties. The Contracting Parties are required by Article XXIII:2 promptly to investigate the matter, and to make appropriate recommendations or a "ruling." Current practice is for the Contracting Parties to refer Article XXIII complaints to groups denominated "panels." The informal nature of the panels is indicated by the change from the earlier use of "working parties," made up of official representatives of contracting parties, to the current reliance on panels of qualified individuals acting in their own right, and also by the appointment of a prestigious panel chairman able to act as a conciliator.

In the DISC case, the failure of the parties to agree upon a reduction led to a reference of the matter to a GATT Panel in 1973. In the meantime, the United States had brought counter-complaints that the direct-tax practices of Belgium, France and the Netherlands also violated GATT Article XVI:B4. The same panel members, sitting concurrently as four separate panels, were named to consider these U.S. charges as well as those of the European Community against DISC.

Once constituted under the Article XXIII procedures, the panel studies the issues, meets with the parties (as did the panel in this case in mid-1976), and then prepares a report. If the panel finds both a violation of GATT obligations by the offending country and a "nullification or impairment" of a GATT benefit to the complaining country, the panel's report is to contain recommendations aimed at bringing about the resolution of the disagreement by the concerned parties. The report is presented at the next meeting of the GATT Council.

Once the panel's report is received by the GATT Council, the Council theoretically has the power to impose whatever sanctions or remedies the panel recommended (within the limitations decreed by Article XXIII, as discussed below). However, any such action is virtually certain to be held for consideration by a session of the GATT Contracting Parties, thus assuring the lapse of at

least an additional six months. That delay, like all of the other delays built into the XXIII procedure, has the effect of further promoting a negotiated settlement of the problem by the parties concerned.

Before sanctions can be imposed, Article XXIII:2 requires that the Contracting Parties find that the circumstances are "serious enough" to justify the imposition of sanctions. A much-quoted Working Party has made it clear that the circumstances are not sufficiently "serious" until all hopes of a negotiated settlement have been dashed, with authorization of sanctions a last resort.[1]

Finally, the Contracting Parties must determine that the proposed sanction or remedy is the "appropriate" action. That determination would require a calculation of the effect of the subsidy on the aggrieved parties and the effect of the proposed remedy upon the grantor of the subsidy, as well as consideration of any "broader economic elements" relating to the alleged impairment or nullification. In the *U.S. Dairy Imports* case, it took a full year to decide what measures were appropriate, after the Contracting Parties agreed that sanctions were warranted.

Even in cases where the Contracting Parties have gone through all of those steps, they are less likely to impose sanctions than merely to recommend that the offending measure be withdrawn. In the DISC case, in fact, the European Community requested only such a recommendation of withdrawal, rather than the authorization of sanctions.

This reluctance to impose sanctions is fundamental to the GATT philosophy concerning resolution of trade disputes. By attempting to resolve disagreements through negotiation and consensus, GATT seeks to avoid the retaliatory tactics of the 1930's. The system embodies a recognition that even those sanctions permitted under Article XXIII do nothing to solve the problem which led to the complaint.

Indeed, even if a measure is found to violate GATT obligations, there is nothing in GATT by which the offending party can be required to remove the measure. Instead, the last resort of the Contracting Parties is to authorize the suspension by the offended party of some GATT concession or obligation running in favor of the country found to be in violation. That suspension typically does not benefit the offended country, but operates only to punish the offender. For example, the U.S. quota on dairy imports harmed Dutch dairy farmers, whose dairy sales would not be aided at all by the retaliatory Dutch limitation on U.S. exports of wheat to the Netherlands. The so-called "remedy" thus would lead to the logical but absurd result of the Netherlands paying higher wheat prices as retaliation for the loss of dairy sales to the U.S.

In summary, then, the GATT procedures for resolution of disputes embody an extended, multi-step process whose goal is resolution by conciliation and negotiation, rather than by mandatory order or imposition of sanctions. Especially in cases where (as is true here) the dispute arises between major members within the GATT, a definitive resolution requires a consensus among the Contracting Parties.

The cases involving DISC and the Belgian, French and Dutch subsidies are still in the preliminary stages of this process. In November, 1976, the GATT Panel rendered its reports on the four complaints, finding in each instance a "*prima facie* case" that the direct-tax practice in question was "in some cases" inconsistent with GATT obligations.

The nature of the reports rendered by this Panel raises some interesting questions as to the procedures which will be appropriate for further GATT consideration of these cases. For reasons which are discussed in greater detail below, the Panel's conclusions were more preliminary than is ordinarily the case.

On one of the basic issues necessary to a resolution of the complaints, no evidence was presented to the Panel by any of the parties. Accordingly, the Panel could not decide the cases definitively, but had to content itself with finding *prima facie* cases based specifically upon rebuttable presumptions. Moreover, unlike the normal report, the findings of this Panel were not accompanied by any recommendations as to the appropriate remedial action.

This leaves the course of future proceedings somewhat uncertain. If the GATT Council accepts the Panel reports (which has not yet occurred because the European Community refuses to permit it), further deliberations by the Council or by a second panel would logically be appropriate, both to afford an opportunity for rebuttal of the first Panel's rebuttable presumptions and to formulate a recommendation for remedial action.

[1] 3d Supp. BISD 250 (1955).

Alternatively, the issue might be dealt with in the framework of the current Multilateral Trade Negotiations, along with related export subsidy questions. Another option would be for the Council simply to "take note" of the Panel's report, leaving it to the parties themselves to resolve the dispute.

Two points are clear, however. First, the issues raised in this dispute are far from a final resolution, and the preliminary conclusions reached by the Panel do not require any action by the United States with regard to DISC. Second, the European Community's complaint against DISC has become a possible vehicle for a more fundamental inquiry into the broader subject of direct-tax export subsidies.

B. The Issues Raised by the Complaint Against DISC.—In its complaint, the European Community charged that DISC is an export subsidy and that its adoption and use by the United States are in violation of Sections A1 and B4 of Article XVI. Section A1 calls for notification of and consultation with other GATT members upon the establishment of an export subsidy:

> 1. If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the Contracting Parties in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidization.

Section B4 sets forth the general GATT prohibition against subsidizing exports of non-primary products[3] in any way which results in bi-level pricing:

> 4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.

With respect to Section A1, the principal question was whether DISC could be deemed a "subsidy" under GATT. That was also a threshold question in the Panel's analysis of Section B4. In the latter section, however, the major question was bi-level pricing—does DISC result in the reduction of export prices below the comparable prices charged in domestic sales? Finally, the Panel had to consider whether any violation of Section B4 is sufficiently injurious to other GATT members that it constitutes a "nullification or impairment" of the benefits which those members are entitled to expect under the General Agreement.

In the DISC case, these issues proved very difficult to resolve. Ultimately, however, the Panel found that the United States had violated the notification provisions of Section A1 (based on its conclusion that one element of DISC is a "subsidy") and concluded—based specifically on a rebuttable presumption as to bi-level pricing—that there was a *prima facie* case that DISC violates Section B4 in such a way as to result in a "nullification or impairment" of GATT benefits.

The manner in which the Panel reached these conclusions is worthy of analysis. It seems fair to state that a court or any other body which relies on evidence, past interpretations and the language of the regulatory provision would not have been able to conclude that DISC violates either Section A1 or Section B4. That the Panel was able to do so underlines the informality and the negotiated (rather than judicial) nature of decisions made under GATT.

C. The Issue of Notification Under Section A1.—Prior to the November, 1976 reports by the DISC Panel, deferral of taxes had never been found to be an export subsidy within the meaning of GATT Article XVI. A previous GATT Working Party Report, issued in 1960, had listed eight practices which it concluded were "generally to be considered as subsidies in the sense of Article XVI:4." Included in that list were two direct-tax practices:

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[3] Section B3, concerning export subsidies for primary products, was not emphasized by the European Community, although U.S. exports of such products through DISC are significant. Canada, intervening in the case, raised the B3 issue, but the Panel rejected it.

(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises.

(d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connection with incorporation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption; or the payment, in respect of exported goods, of amounts exceeding those effectively levied at one or several stages on these goods in the form of indirect taxes or of charges in connection with incorporation or in both forms.[3]

Deferral of direct taxes was not mentioned in the 1960 list. Moreover, there was a significant precedent for *not* regarding such deferral as a subsidy. A Background Note by the GATT Secretariat for a 1972 Working Group on Export Subsidies distinguished "the exemption in respect of exported goods of direct taxes," which "are clearly export subsidies under GATT rules," from deferrals of direct taxes, which do not fall within that clearly prohibited category.[4] From 1958–1966 the British maintained Overseas Trading Corporations, with a tax deferral similar to DISC, without any protests from other nations. In addition, other practices of various GATT members during and after the drafting of Section B4 indicate that many export incentives administered through direct tax systems have not been considered by GATT member countries (including European Community countries) to be export subsidies. The Existence of such practices without challenge over a period of time is accepted as evidence in GATT proceedings that the practices have not been considered as falling within Article XVI.

Two principal arguments were presented to the Panel by the European Community. First, it pointed out that the avowed object of the DISC legislation was to increase exports. This purpose of export-promotion, it was contended, established DISC as an export subsidy. Second, it maintained that in practice the deferral provided by DISC is the equivalent of a direct-tax "exemption" as contemplated by the 1960 Working Party List.

In contending that DISC does not constitute a subsidy, the U.S. representatives noted that it was often difficult for a DISC to continue to meet the 95 percent "qualified export assets" test and this fact, combined with the uncertainties arising from repeated efforts to repeal the DISC legislation, made it unlikely that businesses would regard the DISC deferral as being the equivalent of a tax exemption. This argument was reinforced by the fact that many firms provide currently in their financial statements for the full amount of the deferred tax.

The Panel agreed with the United States that a deferral of taxes—even if of indefinite duration—does not constitute an "exemption" under the GATT rules. Nevertheless, it concluded that DISC is an export subsidy within the meaning of Article XVI. It based that conclusion on the fact that DISC's stated purpose was to increase exports and on the argument that the failure to charge interest on taxes deferred under DISC constituted "a partial exemption" which fell within the 1960 Working Party List.

Having found DISC to be a subsidy, the Panel concluded that the U.S. had failed in its obligation to notify and consult under Section A1.[5] It should be emphasized, however, that this finding stands as little more than a formality. Under Section A1, the only remedial action to be taken is the holding of discussions looking toward possible limitation of the subsidy. Moreover, such discussions are required only where a determination is made "that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization." The DISC Panel made no such determination, and did not recommend discussions between the U.S. and other contracting parties.

In this regard, it should be observed that notification under Article XVI:A1 has been a sporadic practice at best, and has occurred principally with regard to subsidies on primary products. A GATT panel noted in 1961 that only one notification had been received since 1947 relating to subsidization of domestic shipbuilders, although such subsidies are quite common.[6]

D. The Issue of Subsidization Under Section B4.—From the outset, it was recognized by all parties concerned that the major issue for the Panel to resolve was whether the adoption and maintenance of DISC by the United States violates the prohibition set forth in Article XVI:B4. A definitive finding of such violation, coupled with a determination that the violation had caused a nullification or

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[3] 9th Supp. BISD 186–187 (1960).

[4] GATT Doc. COM. IND/W/73, at 12 (Apr. 28, 1972).

[6] 11th Supp. BISD 203–204 (1961).

[5] Although the U.S. never gave the official notification contemplated by Article XVI:A1, it had informally notified GATT of the DISC proposal on August 16, 1971, and had provided further and more detailed information in an "Exchange of Views" later that year.

impairment of GATT benefits, would warrant a recommendation by the Panel either that the U.S. abolish (or limit) DISC or that other affected countries be authorized to take retaliatory measures. Accordingly, most of the debate before the Panel turned on the B4 issue.

The analysis of the European complaint under Section B4 proved exceedingly difficult for the Panel, because of the section's requirement of a finding that the subsidy . . . results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. the Panel, because of the section's requirement of a finding that the subsidy . . . results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

This explicit language has been contained in Section B4 since that section (and indeed all of Section B) was added to Article XVI in 1955, after a tortuous history of attempts to reach a consensus on the difficult issue of export subsidies. The requirement that "bi-level pricing" be found reflects the draftsmen's concern that subsidies not become the vehicle for a resurgence of the price-cutting which had been prevalent in the trade wars of the 1930's.

In consequence, Section B4 does not preclude subsidies such as export promotion assistance or devices to increase the profits from export sales which, although they would clearly be deemed subsidies by an economist, do not result in bi-level pricing.[7]

Despite the explicit bi-level pricing requirement of Section B4, the European Community presented no pricing data whatsoever to the DISC Panel. Instead, the complainants urged that the United States be required to produce price data to show that DISC did not result in bi-level pricing. In support of this guilty-until-proven-innocent procedure, the European nations (joined by Canada) argued that pricing data could be more easily obtained by the U.S. government than by the complainants.

The United States representatives, of course, categorically rejected this effort by the complainants to avoid their burden of proof. In addition, the U.S. pointed out that pricing data was no more readily available to it than to the other parties, and that those studies which have been made on the subject suggested that DISC users had maximized profits by maintaining prices and increasing exports, rather than by reducing export prices.

In the absence of evidence on the crucial issue of bi-level pricing, the DISC Panel was unable to reach a definitive conclusion as to whether DISC violates Article XVI:B4. Instead, they based their finding of a *prima facie* case of nullification or impairment specifically on a rebuttable presumption as to bi-level pricing.

The logic upon which that presumption was based is singularly tortured, and the United States argued strenuously that the presumption was improper.

The basis of the Panel's presumption was the illustrative list of subsidies prepared by the 1960 Working Party. Although the Working Party's report made no mention of the bi-level pricing issue, the DISC Panel accepted the view of the European Community representatives[8] that the subsidies contained in the list could be rebuttably presumed to result in bi-level pricing:

> The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel further noted that these contracting parties considered that, in general, the practices contained in the illustrative list could be presumed to result in bi-level pricing, and considered that this presumption could therefore be applied to the DISC legislation. The Panel concluded, however, from the words "generally to be considered" that these contracting parties did not consider that the presumption was absolute.

A singular aspect of this reasoning is that the Panel never found DISC as a whole to be classifiable in any of the categories set forth in the 1960 illustrative test. To the contrary, the Panel concluded that the basic tax deferral concept of DISC was *not* an "exemption" or "remission" of tax as contemplated by the 1960 list. Indeed, the only element of DISC which the Panel found to be a partial tax

[7] *See* Commission on International Trade and Investment Policy, United States International Economic Policy in an Interdependent World Report, at 91 (1971).

[8] The U.S. representatives accepted this view as to subsidies explicitly named in the 1960 list, but argued that no such presumption is appropriate with respect to practices not specifically enumerated, such as tax deferral.

exemption was the absence of any interest charge on the deferred tax. Thus, the Panel's crucial presumption of bi-level pricing was predicated exclusively upon one minor aspect of the DISC program.

Based upon this rebuttable presumption of bi-level pricing, the Panel "concluded that the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI :4." Here again, the Panel's use of the temporizing phrase "in some cases" appears to reflect the tentative nature of a conclusion based upon presumptions rather than evidence.

There remained the question whether DISC had resulted in a "nullification or impairment" of the benefits accruing to the complaining nations under the General Agreement. On this point, the United States argued that a technical breach of Article XVI :4 was insufficient, and that it was incumbent upon the European Community to demonstrate that it had been injured by the DISC program. In this regard, the position of the U.S. was in accord with that voiced by one of the most respect commentators on the General Agreement:

> The concept of nullification and impairment does seem to imply that there must be some sort of injury to a contracting party before it has the right to invoke Article XXIII under these terms. Thus a mere technical breach of the General Agreement would not suffice as grounds for the invocation of Article XXIII. It would have to cause some "nullification or impairment" first.[9]

Once again, the European complainants chose to present no evidence on this issue, although in this instance they themselves were clearly in possession of the relevant data. Instead, they again urged that the Panel reach its conclusion via presumptions rather than evidence. In this contention, the complainants relied on the report of an earlier GATT panel which dealt with complaints made by Uruguay regarding certain trade practices of industrialized nations. The Uruguayan case, according to the European Community, established the proposition that nullification or impairment may be presumed where a violation of GATT rules is found.

Logically, of course, such a presumption is untenable, since it would amount to abolition of the nullification/impairment requirement in most cases. Moreover, the panel report on the Uruguayan case itself stated that

> Impairment and nullification . . . does not arise merely because of the existence of any measures . . . In implementing the compensation provision . . . the CONTRACTING PARTIES would therefore need to know what benefits accruing under the Agreement, in the view of the country invoking the provisions, had been nullified or impaired, and the reasons for that view.[10]

Nevertheless, the Panel apparently accepted the position advocated by the European Community. Without any discussion or analysis other than a reference to the Uruguayan case, the Panel . . . found that there was a *prima facie* case of nullification or impairment of benefits which other parties were entitled to expect under the General Assembly.

The Panel offered no recommendation as to the appropriate action under GATT to deal with the DISC situation. Its failure to do so is hardly surprising, in light of the nature of its decision. It had found a violation of the Section A1 notification requirement, but had failed to make the finding of "serious prejudice" necessary to bring about discussions among the affected parties. Its finding of a violation of Section B4 was specifically predicated on a rebuttable presumption which related only to a minor facet of the DISC legislation. And its conclusion as to "nullification or impairment" was both based wholly on a presumption and phrased in terms—a *prima facie* case—which invited a rebuttal presentation on the part of the United States.

Clearly, then, the Panel Report necessitates further proceedings under GATT before the DISC issue can be finally resolved. As discussed below, the United States has—quite appropriately—suggested that such further proceedings be integrated with more general negotiations aimed at eliminating tax practices which distort trade. Only the intransigence of the European Community now prevents such discussions.

E. The United States' Complaints Against Belgium, France and the Netherlands.—The direct-tax practices challenged by the U.S. complaints against Belgium, France and the Netherlands are in many ways conceptually analogous to

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[9] Jackson, World Trade and the Law of GATT, at 181 (1969).
[10] 11th Supp. BISD, at 100.

the U.S. DISC program. Each country utilizes a territoriality concept in its income tax policy which allows a company to escape all or the major part of tax liability on income arising from exports. This is accomplished by establishing a branch or subsidiary in a tax-haven country and flowing export sales through that entity. Under Belgian, French and Dutch law, that portion of export income allocable to the off-shore entity is either not subject to domestic income tax, taxed at a lower rate than domestic income, or used to reduce domestic income tax by a tax credit system.

The benefits from this preferential treatment of foreign source income are preserved by a failure to tax dividends paid to the domestic parent by such an off-shore entity. Finally, the flexible application of or failure to enforce intercompany pricing rules allows companies to maximize the benefits of this failure effectively to tax foreign-source income by allocating an unrealistically large portion of total export income to the off-shore branch or subsidiary rather than to the domestic parent. Details of the practices of each country are set forth in Part VII of this White Paper.

Thus, where the DISC program allows a U.S. exporter to achieve a partial deferral of income tax by flowing exports through a special domestic entity, these foreign countries permit an exporter to obtain exemption from income tax by flowing exports through a branch or subsidiary in a tax-haven country. Conceptually, the practices are closely analogous. In practice, the advantages accruing to European exporters are much greater than those obtained by U.S. firms through DISC.

In light of its decision in the DISC case, it was impossible for the GATT Panel not to condemn the practices of the three European countries. Where the Panel had to strain to characterize the DISC deferral as a subsidy (based primarily on the failure to assess interest on the deferred tax), the exemptions received by Belgian, French and Dutch exporters were clearly within the scope of the 1960 illustrative list:

> The Panel found that however much the practices may have been an incidental consequence of [the European countries'] taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market.

Having presumed that the DISC deferral resulted in bilevel pricing, the Panel could not very well refuse to adopt the same presumption as to the exemptions afforded by the European tax practices. In addition, the Panel again relied on the Uruguayan case to presume nullification or impairment of benefits once a violation of GATT rules had been found:

> In light of the above, and bearing in mind the precedent set by the Uruguayan case (BISD, 11 Suppl. p. 100), the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.

Thus, the European Community, having sought to use the GATT procedures to put an end to DISC, found itself hoist on its own petard, with the direct-tax practices of three of its major members condemned by the same logic which it had persuaded the Panel to apply to DISC. As discussed below, this result has opened the door to a general re-evaluation of the GATT rules on direct-tax export subsidies—a re-evaluation which the European Community is now trying vigorously to prevent.

II. Further GATT Proceedings—A Logical Vehicle for Renegotiation of the International Rules

The nature of the four reports issued by the GATT Panel presents for the United States an opportunity for a major new initiative in its continuing campaign to establish more equitable international rules on the use of tax practices to subsidize exports. Because the reports were specifically predicated upon rebuttable presumptions and *prima facie* cases, and because the Panel in each case failed to offer a recommendation as to appropriate GATT action, it is clear that future GATT proceedings will be required in order to reach a fundamental resolution of the issues raised by the complaints of the United States and the European Community. Such proceedings would provide the United States with a forum in which to offer vigorous rebuttals to the Panel's conclusions concerning DISC, and at the same time offer a logical vehicle for a broader international reassessment of the rules governing export subsidization by means of tax devices. The United States is now pressing for further proceedings of this nature. Only the recal-

citrant position adopted by the European Community now stands in the way of such talks.

A. Potential U.S. Rebuttal of the Panel Decision on DISC.—As the foregoing analysis demonstrates, the Panel had great difficulty in determining that DISC infringed GATT principles. In the end, the Panel was forced to rely upon rebuttal presumptions and found only a *prima facie* case of nullification or impairment. The nature of the Panel's decision suggests the following major lines of rebuttal for the United States to employ in further GATT proceedings on this issue:

It Is Not Appropriate To Decide Major GATT Issues On The Basis Of Presumptions. Although the United States strongly supports the GATT procedures for the resolution of international disputes, it should equally strongly oppose the basing of important GATT decisions upon presumptions when complaining parties fail to produce evidence in support of their claims. In the DISC case, the GATT rules explicitly require a showing that the subsidy in question results in bi-level pricing, together with a demonstration that the effect of the subsidy upon the complaining parties is sufficiently injurious to constitute a "nullification or impairment" of benefits which they are entitled to expect under the General Agreement. Despite these explicit requirements, the Panel based its decision on these crucial issues entirely upon presumptions, with no significant evidentiary support for either determination. This aspect of the GATT Panel decision is especially pernicious, because it opens the door to resolution of international disputes on the basis of political considerations rather than on the merits of the issues presented.

The Panel's Presumptions As To "Bi-Level Pricing" And "Nullification Or Impairment" Violates Accepted GATT Principles. The specific presumptions in which the Panel indulged with respect to "bi-level pricing" and "nullification or impairment" are particularly inappropriate, because they contradict accepted GATT principles.

On both issues, the GATT rules are very specific as to the determinations which must be made by the Panel. Before any subsidy can be found to be a violation, it must be determined that that subsidy results in bi-level pricing. And before GATT action can be taken with respect to any violation of the rules, it must be determined that such violation has resulted in sufficiently serious injury to constitute a nullification or impairment of benefits which other parties are entitled to expect under the General Agreement. The Panel's use of presumptions on both of these points directly contradicts the explicit requirements for determinations on these two issues. If it is to be presumed that all subsidies result in bi-level pricing, then the bi-level pricing requirement becomes totally superfluous. Similarly, if it is to be presumed that any violation results in "nullification or impairment", then "nullification or impairment" ceases to be a requirement. Thus, the effect of the Panel's reasoning appears to be that a complainant need only show that the challenged practice constitutes a subsidy. Once that showing has been made, the subsidy automatically becomes a violation of GATT rules by virtue of the presumption of bi-level pricing, and the violation automatically amounts to "nullification or impairment" by virtue of a second presumption. This is obviously contrary to the intent and specific language of the General Agreement.

Moreover, the presumption as to bi-level pricing flies directly in the fact of another accepted GATT principle. As discussed in more detail elsewhere in this White Paper, the General Agreement draws a sharp distinction between remission of direct taxes and remission of indirect taxes. The sole economic justification for that distinction is the presumption that indirect taxes are passed through to the purchaser and are therefore reflected in changes in the price of the product sold, whereas direct taxes are presumed invariably to be absorbed by the seller and thus not reflected in price changes.

The presumption adopted by the present Panel with respect to both DISC and the direct-tax practices of the three European countries is the diametric opposite of the presumption which underlies the direct/indirect distinction. In the DISC case and the companion cases, the Panel presumes that remissions or exemptions of direct taxes *are* reflected in changes in the price of the product, rather than being absorbed by the seller. Obviously, it is inequitable to use one presumption to justify the continued use by foreign countries of indirect-tax remissions to subsidize exports, while at the same time using the directly opposite and contradictory presumption to condemn a direct-tax incentive utilized by the United States.

Rebuttal of the Panel's Presumptions.—The nature and language of the Panel's report on the DISC program specifically invites the presentation of rebuttals by the United States on the issues of bi-level pricing and nullification or impairment. On both points, it appears that the U.S. has strong factual presentations to be made in rebuttal.

The presumption that DISC results in the lowering of export prices below the prices charged in comparable home market transactions stems from a basic misunderstanding of the way in which DISC operates. In point of fact, the lowering of export prices is not a significant effect of DISC. To the contrary, the best available evidence strongly indicates that DISC has expanded U.S. exports (and consequently domestic employment and capital investment), not by underwriting price-cutting in U.S. exports, but by increasing the export orientation of U.S. firms, by increasing the cash flow from export sales, by encouraging more aggressive sales efforts overseas, by providing U.S. companies the security of straightforward and objective rules for inter-company allocation of profits, by affording greater facility with respect to terms of export financing, and by similar non-price benefits.

The partial deferral of income tax liability afforded by the DISC program does not provide an economically justifiable basis for a U.S. firm to reduce the prices of export sales. It must be emphasized that DISC constitutes only a deferral of taxes. The ultimate liability to pay the tax is unaffected. Moreover, the uncertainties arising from the difficulty of continuing to comply with the DISC prerequisites, coupled with periodic proposals by Members of Congress that DISC be repealed or modified, make it especially unlikely that any exporter would revise his pricing structure based upon the DISC benefits. Any such price reduction would, in the long run, reduce the profitability of the export transaction, because the ultimate payment of the tax would have to be calculated as a cost element in the export sale. In this regard, it should be noted that many companies make current provision in their financial statements for the full amount of tax liability deferred under DISC.

The only element of the DISC program which in any way constitutes a permanent cost reduction which might conceivably enable the exporter to reduce prices is the absence of an interest charge on the deferred tax obligations. This minor element of DISC, however, is far too insignificant to serve as the basis for any measurable reduction in prices. In an analysis submitted by Brunswick Corporation to the President's Export Council on May 6, 1975, the value of this interest component, even assuming a 16 percent pre-tax return on export sales and a 10 percent rate of interest, was shown to be an insignificant one mill per dollar of exports:

RATE OF PROFITABILITY ON EXPORT SALES

	16 percent	8 percent	4 percent
Export sales dollar	$1.00	$1.00	$1.00
Pretax income	.16	.08	.04
DISC allowable portion	.08	.04	.04
50 percent tax deferment	.04	.02	.02
Tax at 48 percent	.02	.01	.01
Interest savings at 10 percent	.002	.001	.001
After-tax benefit at 52 percent	.001	.0005	.0005

It should be noted that these figures are predicated upon the DISC provisions which existed prior to the 1976 amendments. The lesser portion of export-related taxes deferrable under the amended DISC program would, of course, reduce even further the value of the interest component.

Moreover, it should be observed that the "bi-level pricing" requirement of Article XVI is that the subsidy be shown to have resulted in export prices "lower than the comparable price charged for the like product to buyers in the domestic market." It is not a requirement simply that prices in export sales be shown to have been reduced to a level lower than they would have been without the existence of the subsidy. As a general matter, the prices of export sales are normally somewhat higher than the prices of comparable domestic transactions, in view of additional cost factors and the increased risk of selling in export. Therefore, even if it could be argued that the omission of an interest charge on the deferred tax enables the exporter to make some

price reduction, the minute size of the benefit attributable to the interest component is clearly insufficient to permit any reduction of prices below the levels charged in comparable domestic sales.

It should also be possible for the United States to offer a persuasive factual rebuttal to the Panel's finding of a *prima facie* case of "nullification or impairment." Such a rebuttal would emphasize, among other arguments, the fact that the exports of the complaining European Community countries have grown significantly since the commencement of the DISC program, some at rates faster than the growth rate of United States exports. In such circumstances, it is difficult to see how the European Community can contend that its exporters have been placed at a significant disadvantage by virtue of the DISC benefits accorded to U.S. firms.

B. The Panel Reports—A Vehicle for a General Reassessment of the International Rules on Direct-Tax Export Subsidies.—It is the position of the United States Government that the four reports issued last fall by the special GATT Panel underline the need for multilateral negotiations on the international rules governing the use of direct-tax incentives to promote exports. This point was made forcefully by then-Special Representative for Trade Negotiations Frederick B. Dent, in a statement issued November 5, 1976:

> I intend to propose consultations with interested governments, immediately following a meeting of the GATT Council at which the panel reports will be filed on November 12, 1976. The purpose of these talks will be to achieve a mutually satisfactory solution to the problem of the trade distortive effects of tax practices. Because of the importance of this widespread problem multilateral as well as bilateral consultations are required as soon as possible.
>
> The Administration believes that an internationally satisfactory resolution is essential rather than uncoordinated unilateral changes in domestic law or policy.

At a meeting of the GATT Council in February of this year, the same position was advanced by the United States representative, urging that the Council accept all four Panel reports as a basis for the commencement of such multilateral negotiations. This emphasis on multilateral discussions aimed at eliminating these trade-distorting direct-tax practices continues to be a major facet of the Carter Administration policy in this area. That fact was underlined by Secretary of the Treasury W. Michael Blumenthal in a letter of April 22, 1977 to the Chairman of the Special Committee for U.S. Exports:

> At (the February) meeting, the U.S. proposed that the GATT Council adopt the Panel report on the DISC together with the Panel reports on the tax practices of France, Belgium, and the Netherlands. In doing so, the U.S. insisted that all such tax practices should be treated in the same manner under GATT and that the U.S. would not block progress on this issue in the GATT.

The Special Committee for U.S. Exports submits that this policy is a desirable and necessary position for the United States to take. Indeed, it is only through the use of a vehicle such as the current Panel reports that there is any possibility of achieving meaningful negotiations on this important international trade issue.

III. The Current Impasse In the Gatt Proceedings

The current posture of the GATT proceedings on the four Panel reports presents a study in contrast between the constructive approach taken by the United States and the intransigent position adopted by the European Community. As noted above, the immediate reaction of the United States upon the issuance of the Panel reports last November was to call for international negotiations on the subject of trade distortions caused by tax-related export subsidies. Subsequently, the United States has continued to press for such negotiations, and has even gone so far as to urge the GATT Council to adopt all four reports (including the one on DISC) as the first step toward such negotiations. In short, the United States is seeking to work within the GATT procedures to resolve what is obviously a major and complex issue in international trade.

The position taken by the European Community has been quite different. Immediately following the announcement of the Panel decisions in November, several of the EC member states categorically rejected the reports relating to

Belgium, France and the Netherlands. In February, when the United States sought to have all four reports adopted by the GATT Council as a first step toward further proceedings on the issues, the European Community refused to permit adoption of the three reports dealing with the European subsidies. Astonishingly, the European nations took the position that the report on DISC should be adopted and that a recommendation should be issued requiring the United States to abandon the DISC program, but that the reports on Belgium, France and the Netherlands should be rejected without further consideration.

Although some observers might consider the European position to be arbitrary and unreasonable, it should be noted that that position is consistent with the European Community's record over the last decade of consistently refusing to permit any serious discussion of changes in the rules governing export subsidies. This consistent recalcitrance has persisted through GATT and OECD Working Party deliberations, as well as in bi-lateral and multilateral discussions, as discussed more fully in Part III of this White Paper. Even now, in a proceeding which they themselves commenced, it is quite clear that the European nations would prefer to maintain their own large direct-tax export subsidies, even if it means failing to achieve their desired goal of forcing the United States to eliminate DISC.

It is not certain how long the European Community will be able to maintain this posture of adamant refusal to negotiate in the face of continuing U.S. pressure. The pendency of the four Panel reports, together with the rapid developments in the indirect-tax area (discussed in Part VI, below), constitute powerful pressure for commencement of the negotiations which the European countries now oppose. Whether meaningful talks will take place is still far from certain. However, one fact is quite clear. Absent very tangible pressure to discuss and resolve these subjects, our "trading partners" simply will not negotiate or compromise. In this case, it is the existence of DISC which has created such pressure, and if DISC were to be unilaterally abandoned by the U.S. this facet of the effort to force renegotiation of the international rules would collapse immediately. Accordingly, it is essential that the United States maintain the DISC program, especially at this time when at long last pressures are mounting on several fronts which offer some real promise of forcing meaningful negotiations.

STATEMENT OF ROBERT L. MCNEILL ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE BEFORE THE SENATE COMMITTEE ON FINANCE HEARING ON TAX REFORM, MONDAY, AUGUST 21, 1978

SUMMARY

1. ECAT is firmly opposed to President Carter's recommendation to eliminate the so-called foreign tax "deferral" provisions.

2. The overseas subsidiaries of U.S. firms are important contributors to the U.S. balances of trade and payments. In 1977 they are estimated to have purchased between $30 to $60 billion of U.S. exports, and to have repatriated $16.5 billion in profits.

3. Elimination of "deferral" would harm their competitiveness since they would be subject to higher taxes than their competitors. Being less profitable, they would have fewer profits to repatriate and would be poorer purchasers of U.S. exports.

4. A first-of-its-kind study recently completed by Arthur Andersen & Co. based on actual financial data from the overseas subsidiaries of 88 American companies demonstrates that the proposal to eliminate "deferral" under the most likely circumstances would result in additional foreign tax payments of $294 million, a U.S. Treasury revenue loss of $88 million, and an overall net tax increase of $206 million to the 88 companies.

5. This would result from the interaction between foreign "withholding" taxes and the U.S. foreign tax credit. Overseas subsidiaries would change their distribution policies so as to minimize tax costs. Most companies would increase their profit repatriation patterns from the historic level of about 50 percent to a new level of about 75 percent.

6. "Deferral" is a universal system. For the United States unilaterally to eliminate it for U.S. firms would damage their overseas subsidiaries with consequent harm to the U.S. economy and U.S. workers.

7. Competition for world markets is tough. Please don't make it any tougher.

STATEMENT

Chairman Long and members of the Committee on Finance, I am Robert L. McNeill, Executive Vice Chairman of the Emergency Committee for American Trade. I am pleased to be with you today on behalf of ECAT to testify in support of retaining the so-called foreign tax "deferral" provisions. The members of ECAT are the heads of 63 large companies with extensive trading and investment activities throughout the world. They believe that the trade and investment activities of U.S.-based multinational companies make vital contributions to the economic well-being of the United States and other nations.

CURRENT TAXATION OF FOREIGN INCOME

We are firmly opposed to President Carter's recommendation to eliminate the so-called foreign tax "deferral" provisions. The consequence of such action would be most harmful to the profitability of U.S. overseas businesses and, therefore, to their competitiveness vis-a-is foreign-owned firms. The result would be a worsening of the U.S. balances of trade and payments. Both U.S. government and private studies clearly demonstrate that the operations of U.S. multinational firms produce net balance of trade surpluses of several billion dollars each year. U.S. overseas investments stimulate U.S. export sales and contribute many billions of additional dollars to the U.S. balance of payments through the repatriation of profits earned abroad. In 1977, these repatriated profits are estimated by the Department of Commerce to have totalled $16.5 billion. The Commerce Department also estimates that for 1977 there was an outflow of $5.0 billion for direct investment abroad, leaving a net surplus on private direct investment account of $11.5 billion to the U.S. balance of payments. Without these profit remittances and balance of trade surpluses, the U.S. balance of payments would be in even worse shape than it is.

Secretary of State Cyrus Vance noted in a February 27, 1978, speech to the National Governors Association that one of every three dollars of U.S. corporate profits is derived from international activities. To lose all or part of these revenues would hurt the domestic operations of U.S. firms. Total revenues would be smaller as would profits and funds for new U.S. investment. Employment would suffer as would the U.S. economy.

It is useful to outline what is at issue. U.S. exports in 1977 were $120 billion. Official studies and private estimates are that from one-fourth to nearly one-half of total U.S. exports are to overseas affiliates of U.S. firms. Accordingly, between $30 billion to $60 billion of 1977 exports from the United States were shipped to these affiliates. And it is these overseas subsidiaries—the best customers for U.S. goods—who would be economically harmed by subjecting their income to current U.S. taxation. Their profits would be taxed at rates higher than those of their competitors who would be paying on a current basis only the tax of the host country.

In general, no country taxes unremitted earnings from operations of foreign affiliates of their corporations. If the United States decided to do so, we can be certain that, in view of current fierce competition for world markets, no country would be likely to follow our lead.

Secretary Vance also noted in his recent speech to the governors that nearly 10 million American jobs currently depend on U.S. exports. Using the estimates of U.S. exports earlier referred to, there are between 2.5–5 million American workers producing exports for the overseas subsidiaries of U.S. firms. If "deferral" were to be eliminated, many of these jobs would be in jeopardy since the major overseas customers of American exports would be economically damaged.

Accelerated taxation of monies earned abroad also could result in U.S. corporate taxpayers being taxed on profits never received. This would be analogous to requiring individual shareholders of American corporations to pay personal income taxes on that portion of undistributed corporate profits used to retire corporate debt or to invest in plants and equipment.

As a practical matter, "tax deferral" is applicable or meaningful only in those cases where the foreign effective rate of taxation is less than the 48% U.S. rate. Where the foreign rate is equal to or higher than the U.S. rate, there is no tax payment due the U.S. Treasury. Where the rates are below the U.S. rate, there is, of course, the obligation to pay the United States the difference between the foreign and the U.S. rate.

Business has long contended that the elimination of foreign tax "deferral" would result in a significant competitive disadvantage to U.S. overseas subsidiaries because they would have to pay higher effective taxes than their foreign competitiors. Now, a study by Arthur Andersen & Co. documents that this, in fact, would be the case. It also shows how ending "deferral" would mean a revenue loss to the U.S. Treasury and a revenue gain by foreign governments. ECAT and the NAM financed this totally independent study. Arthur Andersen & Co. developed and sent a questionnaire to major American companies presumed to have overseas business interests. Eighty-eight companies completed the questionnaire.

The companies covered in the study are broadly representative of American overseas business operations. They account for approximately 37 percent of total U.S. overseas direct investment.

The study shows that in 1976 the 88 companies surveyed repatriated 46 percent of their overseas profits, which is very close to the historic average for all firms of about 50 percent. If the 54 percent of overseas profits that these firms did not repatriate in 1976 had been subject to current U.S. tax, the U.S. Government with no change in distribution policy would have collected an additional $206 million.

The major finding of the study, however, is that with current U.S. taxation of all overseas profits, there would be a significant change in the distribution policies of American-owned companies. The static assumption of no behavioral change, on which Treasury revenue estimates is based, is thus not credible. The study shows that companies would repatriate a substantially higher percentage of their profits than they have in the past. The reason why has to do with the interaction between foreign withholding taxes and the U.S. foreign tax credit.

Most countries levy, in addition to other taxes—including income taxes—a special tax on profits that leave their borders. This is usually referred to as a "withholding" tax on profit remittances. These withholding taxes average 25–30 percent of the amount being remitted but are held to much lower levels of 5–15 percent by virtue of bilateral tax treaties with the United States.

Wihholding taxes qualify for the United States foreign tax credit just like direct income taxes paid to foreign governments. As a higher percentage of profits is repatriated, and the total amount of taxes therefore paid the host countries rises, so does the total of foreign taxes eligible for the foreign tax credit.

Based on the data supplied by the 88 companies, the Arthur Andersen study found that if their overseas subsidiaries had distributed all of their profits in 1976 instead of the 46 percent they actually did, the added withholding taxes paid to foreign governments would have been $416 million. Because of the particular U.S. foreign tax credit positions of these companies, the U.S. Treasury would have lost $88 million because of the additional foreign tax credits the companies could have claimed. The study further found that if the overseas subsidiaries had distributed 75 percent of their 1976 profits, then the additional withholding taxes paid to foreign governments would have been $291 million and the U.S. Treasury would have lost $6 million, again because of the build-up of additional foreign tax credits.

These are not approximate but exact figures. The data supplied to Arthur Andersen by the participating companies was the same provided the U.S. Internal Revenue Service for tax purposes. Financial information was provided for each overseas subsidiary. This data was then computed against the actual foreign tax rates in each of the countries where the American subsidiaries are located so that the results are factual, not assumed.

Taking into account the financial position of each of the 88 companies, the Arthur Andersen analysts concluded that in 1976 the companies could have minimized their total tax payments by repatriating between 75 percent and 80 percent of their overseas profits. This would have resulted in additional foreign tax payments of $294 million and a U.S. Treasury revenue loss of $88 million, for an overall net tax increase of $206 million to the companies.

Again, why would companies do this? The reasons are compelling. Without changing their 1976 distribution pattern (46 percent) and without "deferral", companies could find in future years that their tax credits for payment of the foreign withholding taxes on the remittance of built-up overseas earnings would be greater than the amount that could be applied to U.S. taxes on their current foreign source income for the year.[1] This would result in the loss of a portion of that credit.

[1] A table illustrating the consequences of not increasing distributions is attached to this statement.

The study shows that companies could either avoid this loss by a 100-percent distribution of earnings annually or by seeking the optimum distribution figure. The study shows that for most companies the figure would be about 75 percent. But since foreign subsidiaries need to retain a sizable portion of their earnings to continue growing in the foreign markets, the U.S. companies would need to loan back or reinvest such additional payouts.

If the companies did not behave in the manner predicted, they would have incurred very substantial additional tax costs over the years. To do so would be aberrant behavior.

While the Arthur Andersen study touches on other tax consequences that would flow from the elimination of foreign tax "deferral" by the United States, its primary finding is the absolute need for changes in repatriation behavior. Such changes would lead to revenue losses for the United States Government and tax windfalls for the treasuries of other governments, while placing the overseas subsidiaries of United States companies at a severe competitive disadvantage.

Should the United States eliminate foreign tax "deferral", the best this group of companies could hope for would be to hold their additional tax costs to $206 million. But that amount represented 7 percent of their net aggregate 1976 foreign income. In a competitive world where profit margins often are less than that figure, it is easy to see the adverse competitive consequences that would befall the overseas business of these 88 firms.

Those who advocate the elimination of "deferral" do so in large part because they claim it an incentive to invest abroad rather than at home. They are simply wrong. To eliminate it in the United States would place American overseas subsidiaries in the unique position of being subject to current taxation of their profits by two sovereignties with the consequence of increasing their business costs relative to their vigorous competitors, particularly in the developing regions of the world. "Deferral" provides no such benefits. It simply provides for payment of U.S. taxes on receipt of overseas profits.

As this brief discussion of so-called "deferral" clearly illustrates, a change in one area of U.S. taxation can initiate a series of related actions in other countries that are detrimental to U.S. business abroad. It has taken decades of effort to establish profitable American subsidiaries overseas. Basic changes in the foreign tax "deferral" provisions will damage these subsidiaries and will be harmful to the U.S. economy and U.S. workers. Amreican profits and jobs will suffer as will job-generating exports. A dampening effect on the economy and employment is something no one in American wants.

Competition for world markets is tough. Please don't make it any tougher.

ELIMINATION OF "DEFERRAL"—PROJECTED TAX COST TO 88 COMPANIES FROM FAILURE TO INCUR FOREIGN TAXES ANNUALLY

[In millions]

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	Total
I. No behavioral change for 1976–84—All remaining profits distributed in 1985:											
Additional foreign tax	0	0	0	0	0	0	0	0	0	$4,160	$4,160
Additional U.S. tax collected (lost)	$206	$206	$206	$206	$206	$206	$206	$206	$206	[1] (970)	884
Total additional company cost	206	206	206	206	206	206	206	206	206	3,190	5,044
II. All withholding taxes incurred annually:											
Additional foreign tax	416	416	416	416	416	416	416	416	416	416	4,160
Additional U.S. tax collected (lost)	(88)	(88)	(88)	(88)	(88)	(88)	(88)	(88)	(88)	(88)	(880)
Total additional company cost	328	328	328	328	328	328	328	328	328	328	3,280
Additional tax cost if withholding taxes are not incurred annually											1,764

[1] Equals $88 lost for 1985 and $294 lost from carrybacks to each of the years 1982-84.

ELIMINATION OF "DEFERRAL"

THE EFFECTS OF ADDITIONAL FOREIGN TAX PAYMENTS ON U.S. TREASURY REVENUES AND COMPANY TAX COSTS

A study of the actual results for 88 U.S. companies

I. INTRODUCTION

In its 1978 tax proposals, the Administration recommends changing the existing tax structures by imposing U.S. income tax currently on the earnings of foreign subsidiaries of U.S. firms even though such earnings have not been paid to the U.S. firms as dividends. This is generally referred to as eliminating "deferral" of taxes on foreign earnings.

When fully implemented in 1981, the Administration's proposal would change our tax policy relating to earnings of foreign subsidiaries by taxing such earnings to a U.S. parent on an anticipatory basis, even though those earnings might not have been realized by a U.S. entity. Under the Administration's proposal, foreign subsidiary profits and losses would be includible in the tax return of the U.S. parent company currently, and U.S. tax would be collected to the extent that the U.S. tax liability exceeds foreign tax already paid on the profits.

It has been assumed by many that the published revenue estimates accurately reflect the magnitude of the additional revenues to be collected by the U.S. Treasury. It is further assumed that these estimates, if accurate, represent the total additional tax costs to United States corporations. This, in urn, leads to the conclusion that the amounts involved are not significant. Many critics of present law have asked why American business so vigorously opposes current taxation of foreign earnings since these figures are so low.

This study was conducted to determine what the exact U.S. government revenue collections and over-all company tax costs would be for a sample of U.S. companies using tax calculations based on the firms' actual tax and financial data. The study included 88 U.S. manufacturing companies with significant foreign subsidiary operations. The names of these companies are listed in alphabetical order in Appendix A attached to this report. The aggregate net after-tax foreign subsidiary income of the study companies for the year was approximately $2.853 billion. The total foreign dividends and other imputed income taxable to these companies was 46 percent of aggregate net income.

The study involved calculation of the exact consequences that the elimination of deferral would have on these companies, using actual tax return and financial data supplied by the firms for the most recent available year (generally 1976). The calculations were made usign the present U.S. tax rate (48 percent). It also assumes foreign tax laws remain unchanged. The purpose of this report is to present the overall results of that study. (The results were also calculated using a 44 percent U.S. tax rate as proposed by the Administration. Since enactment of a rate change is at best questionable the 44 percent rate results are not described in detail in this report. They are summarized in Appendix D, however.)

The study was financed jointly by the National Association of Manufacturers (NAM) and the Emergency Committee for American Trade (ECAT). Arthur Andersen & Co. prepared the survey questionnaire, received the data and calculated the results.

II. CONCLUSIONS

A. Summary of study findings

Since this study is based on actual tax return and financial data, it has been possible to calculate what the tax consequences to this group of companies would be under various options that would be open to them if deferral is eliminated.

The results are very revealing. They show decisively that it would not be in the best interest of companies to respond in the fashion generally assumed in estimates of government revenue collections. The Treasury's published revenue estimates assume there would be no behavioral changes by companies if deferral is eliminated, that is, companies would follow historical policies of distributing income from foreign subsidiaries to the parent company and would not exercise any of the options available to them in making tax payments to host governments.

Although possible behavioral changes were not dealt with in the Administration's published revenue estimates, the U.S. Treasury has made clear that some could be anticipated. Considerations such as responsibility to shareholders can

be counted on to cause companies to seek the most advantageous methods of handling their finances. If the Administration's proposal is enacted, the companies will have to take into consideration a number of factors. They will compute the potential costs of withholding taxes that would be paid to host countries on the distribution of dividends to the parent. These withholding taxes can provide a tax credit against U.S. taxes on foreign source income but there is a limit on the use of the credit and credits above that limit in a given period would be lost.

Also some countries (for example, Canada and the United Kingdom) offer companies various options in determining local corporate income tax, such as depreciating for tax purposes new investment at the time it is made rather than over a period of years as is the American practice. This can mean lower taxes in some years and higher ones in others. Again, the amount of foreign taxes paid in the years of higher taxes can exceed the amount that can be used as a tax credit in the United States.

Understandably, foreign subsidiaries will adjust their policies of distributing dividends to their parents and of using the depreciation and other options on payment of their local taxes to obtain the best possible tax treatment. Taking account of these likely behavioral changes puts a new perspective on the revenue estimates.

The study involved the determination of the actual tax consequences that would have occurred to the participating companies for 1976 assuming no behavioral change, and the consequences that would have occurred had they changed their distribution patterns and their policies of local tax payments. The results for the 88 study companies were then used to project the likely results for all U.S. companies on the assumption that the study group constitutes a representative sample of all U.S. companies.

The most important conclusion to be drawn from the study is that if deferral is eliminated companies will be forced to accelerate the payment of foreign income taxes which are presently postponed. If this happens for the 88 study companies, the findings of the study indicate there would be a substantial additional tax cost to the companies, a substantial revenue loss to the Treasury, and all of the revenues would go to foreign governments. In short, if deferral is eliminated, the U.S. companies *and* the U.S. government would *both* be losers, and foreign governments would be the beneficiaries. It is likely that the same conclusions would have resulted if comparable calculations had been made for all U.S. companies with foreign subsidiary operations.

The following summaries the results that would have occurred if deferral had been eliminated for 1976 based on assumed behavioral patterns.

No behavioral change

Results for 88 study companies: If deferral had been eliminated with no change in distribution policy and with no other behavioral change, additional U.S. tax revenues of $206 million would have been collected from the 88 study companies for 1976. This represents the U.S. tax on the 54 percent of undistributed taxable profits of the foreign subsidiaries. This would have constituted the net worldwide tax increase for these companies. It is approximately 7 percent of the aggregate net income of the foreign subsidiaries in the study.

Likely results for all U.S. companies: The Treasury estimates that elimination of deferral for all companies for 1976 would have produced additional tax revenues of $550 million with no change in behavior. This represents the U.S. tax on the undistributed taxable profits of the foreign subsidiaries of all companies. The $206 million revenue gain calculated for the 88 study companies is approximately 37 percent of the revenue estimated for all U.S. companies.

Change in distribution pattern—increased foreign withholding taxes

Results for 88 study companies: If 100 percent of the foreign subsidiary profits had been distributed, the aggregate increase in foreign tax cost would have been $416 million and the U.S. Treasury would have suffered a net revenue *loss* of $88 million. If the distributions had been equal to 75 percent of foreign profits (or actual distributions, if greater), the increase in foreign tax cost would have been $291 million and the revenue loss to the U.S. Treasury would have been $6 million. It is likely that with deferral ended actual distribution practices would have varied on a company-by-company basis with each company keeping its increase in current taxes to the minimum possible amount, based on its own

foreign income and tax credits, and at the same time minimizing its worldwide tax costs in the long run. If actual distribution practices of the study companies had been so structured for 1976 and no other behavioral changes had occurred the additional foreign tax payments would have been at least $294 million and the U.S. Treasury revenue loss would have been $88 million.

Results for all U.S. companies: If 100 percent of all foreign subsidiary profits had been distributed, the aggregate increase in foreign tax cost would have been over $1 billion and the U.S. Treasury would have suffered a net revenue *loss* of $235 million. If all subsidiaries had followed the practice of distributing 75 percent of profits (or actual distributions, if greater) the increase in foreign tax cost would have been $777 million and the revenue loss to the U.S. Treasury would have been $16 million. If each U.S. company had followed the pattern of distribution which kept its increase in current and long run taxes to a minimum the additional foreign tax payments would have been at least $785 million and the U.S. Treasury would have suffered a net revenue loss of $235 million.

Change in distribution pattern and current payment of deferred foreign taxes

Results for 88 study companies: If the foreign subsidiaries had distributed 100 percent of their 1976 profits *and* had foregone the rapid depreciation and similar options available to them under local tax laws, the additional foreign tax cost to these companies under this combined change in behavior would have been $530 million and the U.S. Treasury would have suffered a net revenue *loss* of $153 million from the study companies. It is most likely that with deferral ended each company would have adopted the combined pattern of distributions and foreign tax options which kept its increase in current tax costs to the minimum possible amount, based on its own foreign income and tax credits, and at the same time minimized its worldwide tax costs in the long run. If such a combination of behavioral patterns had been adopted by each of the study companies for 1976 the additional foreign tax cost to these companies would have been at least $359 million and the U.S. Treasury would have suffered a net revenue loss of $153 million.

Results for all U.S. companies: If all foreign subsidiaries had distributed 100% of their 1976 profits *and* had foregone the rapid depreciation and similar options available to them under local tax laws, the additional foreign tax cost to the U.S. companies under this combined change in behavior would have been over $1.4 billion and the U.S. Treasury would have suffered a net revenue *loss* of $408 million. If each U.S. company had adopted the combined pattern of distributions and foreign tax options which kept its increase in current and long run taxes to a minimum, the additional foreign tax cost to all U.S. companies would have been at least $958 million and the U.S. Treasury would have suffered a net revenue loss of $408 million.

The Administration's proposal includes an estimate of revenue gain for the years 1979–1983. The first full year for which the elimination of deferral would be fully effective would be 1981. It is possible to project the 1976 results for all companies forward to 1981 using the relationships developed in this study. Those projections are summarized in Appendix B.

B. *Illustration of potential adverse consequences based on study findings*

The adverse consequences that would occur from failure of U.S. companies to change behavior after elimination of deferral can be illustrated in a very simplified way by extending the results for the 88 study companies over a period of years and assuming all undistributed profits are distributed at the end of that period. Assume that for a ten year period (1976–1985) the study earnings remain constant and the companies continue their historical pattern of distributing overseas income and claiming the available foreign tax provisions. The 1976 distribution pattern for these companies is very similar to the distribution pattern for all U.S. companies as evidenced by published statistics.

Obviously the assumptions that future earnings, taxes and distributions will remain unchanged and that all profits will be distributed by 1985 are arbitrary assumptions. They therefore cannot be used to predict the magnitude of future consequences to the companies nor to the actual time frame within which such consequences will occur. Such assumptions do, however, make it possible to illustrate conceptually how a change in the law is likely to penalize the U.S. companies in the form of higher worldwide taxes if they don't adjust their patterns of distributions and foreign tax payments.

If the 88 companies continued to distribute profits as they did in 1976, and if deferral were ended, the companies would have to pay the U.S. Treasury an additional $208 million for each of the first nine years. This would be the tax on the profits retained overseas. As long as these profits are not distributed the companies would not have to pay any additional foreign withholding taxes to foreign governments during these years. However, when the companies distribute their accumulated earnings in 1985, they will incur foreign withholding taxes of $4,160 million. The U.S. Treasury's foreign tax credit rules would only allow $970 million of that amount to be used as a tax credit in 1985. This $970 million would offset all but $884 million of the U.S. taxes on the 88 companies' foreign source income during the ten year period. The total tax payments of the 88 companies during this period would be $884 million to the United States and $4,160 million in withholding taxes to foreign governments—a total of $5,044 million. (This is shown on the attached schedule.)

The 88 companies, of course, do not have to maintain their historical distribution patterns. They could distribute all their overseas earnings each year or they could choose a figure between the historical 46 percent and one hundred percent. Assuming they chose to distribute 100%, they would incur additional foreign taxes of $416 million for each of the ten years. This would produce a total foreign tax cost of $4,160 million over ten years. Because the withholding taxes paid each year would be credited against the U.S. taxes owed on their foreign earnings, no U.S. tax would be collected and, in fact, the U.S. Treasury would lose $88 million in taxes for each of the ten years. The results would be the same $4,160 million of additional foreign taxes paid over the ten year period. The companies, however, would have used their full available tax credits in the U.S. ($880 million) making their total tax consequences only $3,280 million. By distributing their profits currently they would have avoided incurring a "penalty" in the form of an extra $1,764 million in taxes.

The remaining text of this report describes in some detail the reasons for undertaking the study, the behavioral changes assumed by the study and the manner in which the calculations were made.

Much of these descriptions is highly technical in nature, but that is the nature of the subject. It is important that policy-makers be aware that the taxation of foreign source income is not a topic which can be explained simply. U.S. tax law necessarily interacts with foreign tax laws in this area. This is a principal reason why the actual revenue impact of an end to deferral cannot be calculated in a vacuum; it must be considered in conjunction with other actions.

III. DETAILED EXPLANATION OF THE STUDY

A. Nature and purpose

This study involved the determination of the consequences that elimination of deferral would have with respect to a group of 88 U.S.-based multinational companies. We calculated the U.S. tax revenues that would have been collected by the U.S. Treasury and the overall foreign and U.S. tax costs that would have been incurred by the companies studied for 1976.

Calculations were made to determine the revenue collections of the Administration's deferral proposal based on the actual distributions made by the companies for the year studied (this is the asumption used in published revenue estimates). The study then compares the results that would have occurred both if a full (or substantially full) distribution had occurred as described above and if foreign corporate income taxes were not deferred by utilizing various provisions of foreign tax laws.

The calculations were based on actual tax return and financial data for each foreign subsidiary of each U.S. company and determined by applying present U.S. tax law as modified by the Administration's proposal to tax subsidiary income currently. The calculations assume that foreign law and tax rates remain unchanged. Since the study reflects the annual profits, taxes and distributions of the most recent year for which tax return data is available, it is as up to date as any study that could be made. The data base and method of making the calculations are described in detail below. We feel the results correctly quantify the effects of eliminating deferral on the 88 study companies and, in fact, produce the same results that would have occurred had the study companies actually been subject to current taxation.

The study involved calculation of the following for each of the 88 study companies:

1. the additional revenue that would have been collected (or lost) by the U.S. Treasury from the study companies if deferral had been eliminated with no change in behavior or in distribution policy;

2. the additional revenue that would have been collected (or lost) by the U.S. Treasury and the overall foreign and U.S. tax costs that would have been incurred by the companies, if deferral were eliminated and each company had changed its behavior by:

(a) adopting a 100% distribution policy or otherwise incurring all foreign withholding taxes; the same calculation was also made based on the greater of actual distributions or 75% of annual profits;

(b) incurring foreign income taxes equal to the foreign tax expense accrued for financial reporting purposes;

(c) both items (a) and (b) above.

A major purpose of the study was to develop the relationship between (1) the revenues that would be collected by the U.S. Treasury if deferral were eliminated and no behavioral change takes place, and (2) the overall foreign and U.S. costs to the study companies from the elimination of deferral under the assumption of incurring the full or substantially full foreign tax rate currently. Assuming that the study companies are representative of all American companies that would be impacted by the Administration's proposals, it is reasonable to assume that these relationships would be indicative of the impact on revenue collections and tax costs of all U.S. companies. Based on these relationships and the published Treasury revenue estimates, it is possible to project the effect of the full foreign tax rate or U.S. revenues and tax costs for all companies.

B. Treasury estimates of U.S. revenue collections

The Treasury is understood to have estimated that elimination of deferral would have resulted in a revenue gain to the U.S. government of $550 million for the calendar year 1976. This is based on a 48% U.S. corporate tax rate. The comparable estimate for 1981, the first year for which the deferral proposal would be fully effective, is $808 million of revenue gain.

It appears that the Treasury estimate was initially determined by a calculation based on 1972 foreign subsidiary income and foreign taxes. The 1972 calculation was projected forward to 1976 based on actual changes in foreign subsidiary retained earnings, and was adjusted for changes in the law made between 1972 and 1976. The 1976 estimate was then projected forward to 1981 and subsequent years using an estimated growth factor of approximately 8%.

We understand that the Treasury calculations were made using the same basic principles as those in our study except for the method of applying the credit limitation. In our study, the limitation was applied on a company-by-company basis, as would be the result if actual tax returns were filed. We understand the Treasury calculation may not have applied the limitation on a company-by-company basis but rather on an industry group basis. There is no reason to believe Treasury's estimate is not an accurate estimate of revenue gain, however, and, in fact, the conclusions drawn from this study assume the Treasury has correctly estimated the expected revenue collections on the assumption of no behavioral change—that is, no change in the percentage of profits remitted by foreign subsidiaries to their U.S. parents.

We understand the above figures do not reflect and adjustment for the effects of the recently adopted Section 1.861–8 regulations relating to allocation of deductions to foreign income. These regulations became effective for 1977 and, based on our experience many, if not most, companies have not yet determined their effect on the foreign tax credit. Treasury has attempted to estimate the impact of these regulations for 1976 on interest and research expenses (only). This is on the basis that the so-called "branch" approach to elimination of deferral proposed by the Administration would have a different effect under these regulations than the traditional "Subpart F" approach. Treasury has estimated that the allocation of regulations for 1976 on interest and research expenses (only). This is on the basis interest and research expenses under the branch approach would have reduce its $550 million estimate of 1976 revenue gains by $30 million, to $520 million. It has further estimated that the effect in 1981 will be to reduce the revenue gain of $808 million by $40 million, to $768 million.

We have not attempted to quantify the effect of these regulations on revenue collections of the study companies. In our judgment such an attempt would be far too speculative. It is believed that Treasury's estimate likewise is speculative. Moreover, it covers only two of the deductions that may be affected. We believe

that some of the deductions that are not considered, such as general and administrative expenses, are likely to be substantial and thus the impact of the new regulations could be quite different than Treasury has estimated.

For purposes of comparison, therefore, the calculated revenue cost for the 88 study companies can be compared only to Treasury's estimates under the traditional approach, which are $550 million for 1976 and $808 million for 1981. It is not comparable to the lower estimates of $520 million for 1976 and $768 million for 1981.

C. Need for companies to incur foreign taxes currently

The consequence of eliminating deferral is that U.S. companies will immediately include all controlled foreign subsidiary income and creditable foreign taxes in their tax returns, even though the income might not be distributed to the U.S. Under U.S. law foreign taxes are creditable only when they become actual liabilities or payments to the foreign governments. Generally, income earned by the foreign subsidiary is subject to only part of the full foreign tax rate. If deferral is eliminated, U.S. companies will have to ensure that the timing of the income inclusions in the U.S. and foreign tax payments do not result in double taxation (The double taxation potential is explained under Foreign Withholding Taxes and Foreign Corporate Income Taxes below). The only way most companies will be able to avoid long run double taxation is to incur the full, or substantially full, foreign tax rate on an annual basis. This can be accomplished only by (1) incurring most or all of the anticipated foreign withholding taxes on the foreign earnings each year, and (2) avoiding the use of foreign tax provisions which reduce substantial foreign corporate income tax payments currently and defer them until later years.

The paragraphs below describe the reasons why U.S. companies are most likely to take such actions. In this study, the results are based on actual income figures for 1976, assuming that foreign tax provisions and withholding tax rates would remain unchanged.

1. *Foreign withholding taxes:* According to Treasury statistics, foreign subsidiaries of U.S. corporations distribute approximately 45% of annual profits and retain the balance overseas.[1] If deferral is eliminated, then approximately 55% of profits retained by the foreign subsidiaries will become subject to U.S. taxation currently and will be technically treated as "previously taxed" income. This income will be allowed to be distributed without additional U.S. tax in the future since it will have already been taxed in the U.S. However, such income will be subject to additional foreign income taxes in the form of withholding taxes at the time of distribution.

If a large portion of a foreign subsidiary's profits were retained overseas, an accumulation of previously taxed income would build up which would have to be distributed to the U.S. parent at some time. The imposition of foreign withholding taxes would be postponed until the distribution is made. When such accumulated income is distributed, the amount of withholding taxes imposed could well exceed the U.S. parent company's ability to claim such taxes as foreign tax credits applicable to the year of the distribution or to the carryback/carryforward years in which such foreign tax payments can be claimed. The result would be the same as two taxes imposed on such income. The foreign withholding tax could not be used as a credit against U.S. taxes on the distribution because the distributed income was taxed in an earlier year. The result is a substantially higher tax than would occur if the foreign taxes were paid in the year the profits were earned. Appendix C contains an example showing how such double taxation could occur. The Administration's proposal would provide a somewhat longer period of years for claiming the credits, but no carryover would be sufficient to cure this problem in the long run.[2]

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[1] See *U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations* by Gary Hufbauer and David Foster, p. 43.

[2] It should be noted that certain proposals made in prior years to eliminate deferral have included adjustments in the credit limitation provisions similar to that presently available under subpart F of the Internal Revenue Code (sec. 960(b)). However, based on our experience with international companies these provisions probably would not prevent a company from incurring substantial double taxation resulting from withholding taxes unless most or all foreign withholding taxes are incurred on a year-by-year basis, as earned. It should also be noted that drafting a foreign tax credit limitation to avoid this problem probably would not be possible without allowing an unlimited carryback of foreign tax credits, or without merely allowing an imputed credit for assumed withholding taxes in the year the earnings are taxed. In the latter case, termination of deferred would produce the same results as a 100 percent distribution of profits. A section 960(b)-type provision is not included in the administration's proposal to eliminate deferral.

In order to avoid unnecessarily large overall tax costs in the long run, U.S. companies would be forced to incur the full amount of foreign withholding taxes on an annual basis. This presumably could be accomplished, to the extent practicable, by a 100 percent distribution of profits annually so that withholding taxes would be paid currently. For some companies such a full distribution of profits would produce more overseas taxes than could be absorbed by available foreign income. Such companies presumably would limit distributions to that amount which does not create unnecessary excess tax costs on a current basis but minimizes excess credits in the long run. In any event it is likely that most U.S. companies will cause sufficient distributions to at least use the maximum allowable current credits to minimize worldwide taxes over the years.

Although a 100 percent distribution preatice would appear to be a radical change in management policy, it is a reasonable assumption that such a full or substantially full distribution could, and would, be a prudent decision to avoid unnecessary loss of earnings and erosion of capital. Such a policy could undoubtedly be accomplished in most foreign countries without a substantial reduction in the overseas company's working capital by using a distribution followed by an immediate reinvestment or loan of the cash back to the subsidiary. The cash needed to pay the taxes to the foreign governments could be generated internally or borrowed by the U.S. company in the U.S.

2. *Foreign corporate income taxes:* Income earned by foreign subsidiaries generally is subject to a corporate level tax corresponding to our own corporate income tax. Each country imposes a tax based on a statutory tax rate applicable to taxable income determined under local tax accounting rules.

Many countries, including those in which there is substantial U.S. investment, have tax rules which permit companies to postpone corporate income taxes or even to accelerate such tax payments through the use of various tax deductions or allowances such as immediate or accelerated write-offs of capital investments and inventory write-downs. These types of allowances amount, in effect, to an advance deduction of what normally would be allowable deductions in the future under U.S. tax principles. In some countries, substantial amounts of tax payments can be deferred for significant periods, in which case the effective rate of current foreign tax is substantially lower than would be the case if the foreign statutory tax rate were applied to taxable income as determined by U.S. tax accounting rules.

If deferral of U.S. tax is eliminated, U.S. companies will be required to apply U.S. rules to determine the amount of U.S. tax on the foreign subsidiary earnings. Companies which defer significant amounts of foreign corporate income tax payments will build up substantial accumulations of deferred tax liabilities which, when ultimately paid to foreign governments, could far exceed the company's ability to credit the taxes in the year of actual payment or in carryback/carryforward years. Under the circumstances it would only be prudent to pay higher current foreign taxes than to postpone the foreign taxes and pay higher long run taxes.

D. Description of the data base and method of calculation

1. *Companies included in the study:* Manufacturing companies in the combined membership of the NAM and ECAT were requested to participate in the study. Requests to participate were sent to approximately 185 companies which were thought to have foreign subsidiary operations, plus 30 additional companies which possibly had such foreign operations. The companies were requested to respond by providing the tax return data described below. Of companies requested, 88 responded with the data within the time frame allowed and were included in the study.

The names of the participating companies are provided in Appendix A. The foreign subsidiary pre-tax earnings of these companies total approximately $5 billion, and their after-tax earnings were $2.85 billion.

2. *Data collected:* Each company participating in the study submitted on a confidential basis the following data for each of its controlled foreign subsidiaries: country of incorporation, ownership percentage, tier structure, pre-tax profits, certain translation adjustments, current foreign tax expense, foreign tax provision, dividends paid from the current year's profits, Subpart F income, stock ownership percentage, lower tier foreign dividends, and foreign taxes paid on lower tier dividends. In addition, each company was requested to supply foreign taxes paid and the amount of the foreign tax credit limitation for the U.S. company.

The data related to the most recent taxable year for which information was available. In most cases this was calendar or fiscal 1976, but in a few instances the data was from fiscal 1977.

The data included in the study was not audited or otherwise verified by Arthur Andersen & Co. However, the data received from each company was reviewed closely for reasonableness and internal consistency. Where necessary, questions were clarified by contacting personnel from the company.

3. *Method of calculation:* The study involved the calculation of U.S. and foreign tax on the current year's foreign subsidiary profits for each company under each of the following different set of facts:

(a) Current U.S. tax law and actual distributions made by controlled foreign corporations to the U.S. company;

(b) Elimination of deferral and;

1. no behavioral change (i.e., actual distributions and foreign taxes),
2. 100% distribution of profits,
3. 75% distribution of profits (or actual distributions, if greater),
4. actual distributions, but based on foreign taxes accrued for financial statement purposes rather than foreign taxes currently payable,
5. Same as (4) but with 100% distribution of profits.

The additional revenue that would have been collected by elimination of deferral for each of the 88 study companies under each set of facts in b(1) through b(5) was determined by subtracting the U.S. tax cost on actual dividends paid out of current year profits from the U.S. tax that would have resulted had the foreign subsidiary income or loss been included in the tax return of the U.S. company. The calculations assume the U.S. corporation included all controlled foreign subsidiary profits and losses currently in income, and claimed a foreign tax credit for foreign taxes currently payable. Appropriate adjustment (described below) was made to reflect the U.S. company's foreign tax credit limitation as reported on the tax return. The net additional U.S. revenues collected or lost and additional foreign taxes for each of the 88 companies were aggregated to determine the combined results under each set of facts.

Under each set of facts, the U.S. corporate tax rate applied was the present 48% U.S. rate. Foreign withholding taxes were calculated based on the tax rate currently in effect pursuant to local law, as modified by the applicable treaties between the countries involved. For example, withholding taxes on distributions to the U.S. were calculated based on the rate applicable to dividends to the U.S. Adjustments to foreign profits were made for actual distributions between tiers. Failure to take such distributions into account would result in double counting of such profits. Withholding taxes applicable to distributions between controlled foreign corporations in a chain of ownership were based on the rates applicable for the countries involved. In all cases foreign taxes that were, or would be incurred on distributions between tiers were taken into account.

Under each set of facts, the available foreign tax credits were computed under current U.S. tax law, and the credit limitation provisions were applied to each U.S. company as if that assumption had been in effect. The separate limitations applicable to oil companies were applied as required by the tax law, based on additional information received from the oil companies included in the study.

The effect that the credit limitation would have on U.S. revenue collections was determined on a company-by-company basis using the excess limitation or excess credits as reported on each U.S. company's tax return as filed. Thus, for each U.S. company if the elimination of deferral under any set of facts would produce a loss of U.S. revenue (or tax saving to the company) as compared to actual dividends, the amount of such revenue loss would be limited to the company's reported excess limitation. Where the elimination of deferral would have produced an additional tax, the amount of such additional tax (or U.S. revenue) was reduced by any existing excess credits. The single exception to this method of adjustment occurred with respect to one U.S. company which had a taxable U.S. loss for the year.

The adjustment for the company's available limitation has the effect of treating U.S. tax as paid at 48% of taxable income. It thus could differ slightly from a limitation recomputed based on all taxable income because the applicable rate for computing the limitation could be somewhat lower than 48%. Reasons for the difference are the corporate surtax exemption, the Western Hemisphere Trade Corporation deduction and capital gains rates. The effect of the capital gains rate difference was eliminated for most of the companies for 1976, and the phaseout of the WHTC rate difference started in 1976. As a consequence, any differences between the limitation adjustment applied in our calculation and a

full recomputation based on the additional foreign income would be minimal and the results could be said to be virtually equal to those that would have resulted if the U.S. company had re-filed its tax return on the basis of the law with deferral eliminated and the set of facts assumed.

IV. EFFECTS OF CHANGES IN DISTRIBUTION PATTERNS

A. No Behavioral Change

1. *Results for 88 study companies:* The after-tax income that was taxable to the 88 study companies as dividends and/or Subpart F income under current law was $1.310 billion for 1976. This represents 46% of net income of $2.853 billion.

The aggregated results of our calculations show that if deferral were terminated and actual distributions and foreign tax liabilities remained as reported for 1976, the additional U.S. tax revenue collected from the 88 companies would have been $206 million. This amount would have been the net increase in worldwide taxes for these companies. It represents approximately 7% of the aggregate net income of the foreign subsidiaries.

The $206 million of additional U.S. Treasury revenue calculated for the 88 study companies is 37% of the Treasury's estimate of $550 million for all U.S. companies for 1976. Assuming the Treasury's estimate is correct, and assuming the study companies constitute a representative sample of all U.S. companies, then it is reasonable to conclude that the study company results under varying behavioral assumptions represent approximately 37% of the results that would have occurred for all companies for 1976. This relationship is used to project the results for all companies in the sections below.

B. Increased Foreign Withholding Taxes

1. *Results for 88 study companies:* On an aggregated basis, the study shows that a change in the law, accompanied by a change in distribution practice, would produce substantially different results for the study companies If all foreign subsidiaries had followed a 100% distribution practice, the result would have been a net revenue loss to the U.S. Treasury. The amount of the loss in the aggregate for these companies for 1976 would have been approximately $88 million. In other words, instead of collecting $206 million from elimination of deferral, the U.S. Treasury would have lost $88 million if the foreign earnings had been fully distributed.

The revenues that would otherwise be collected by the U.S. Treasury upon elimination of deferral would not be collected under a 100% distribution assumption because they are completely offset, in the aggregate, by foreign withholding taxes on profit distributions. The overall foreign tax rates for the 88 study companies in the aggregate exceed the 48% U.S. rate and the U.S. Treasury would lose, rather than collect, revenue. The loss of revenue occurs because part of these foreign taxes offset U.S. taxes on other foreign income, such as royalties, supervision fees and interest received from the foreign subsidiaries.

We also calculated the results that would have occurred if 1976 distributions were equal to 75% of foreign subsidiary profits (or actual 1976 distributions, if greater). This more conservative calculation was made recognizing that U.S. companies might follow policies which result in substantially full distribution but not fully 100% of annual profits. The 75% figure was selected as an assumed distribution rate for the study because it is about half way between the over-all average actual payout and 100%.[3] On an aggregated basis, the 75% distribution practice would result in no revenue collection from the 88 study companies and in fact would result in a slight revenue loss of $6 million. In other words the U.S. revenue gain of $206 million that would have occurred based on no behavioral change would have been completely eliminated if the companies had followed a 75% distribution practice.

The increase in total (foreign and U.S.) tax cost under the 100% distribution assumption for the 88 study companies would have been $416 million for the year studied. Under the 75% distribution assumption, the increased foreign tax cost would have been $291 million. In other words, the tax cost to the U.S. companies from elimination of deferral would have been greater than the amount of U.S. revenue collection that would have resulted had no behavioral change taken place. The foreign governments, rather than the U.S. government, would have collected these taxes.

[3] Based on published Treasury data, the actual payout for all U.S. companies is about 45 percent. The total taxable dividends and subpart F income for the 88 study companies for the year studied was 46 percent.

It is in each company's interest to minimize current tax costs, based on its own income and credits. The actual distribution practices followed, therefore, can be expected to vary on a company-by-company basis. Companies that can offset all foreign tax payments against U.S. tax currently will find it desirable to follow a 100% distribution practice to avoid large accumulations of unusable credits in subsequent years. Companies that are limited in their ability to utilize foreign taxes currently will tend not to distribute 100% of profits; they are, however, likely to incur at least the maximum amount of additional foreign tax that can be absorbed currently. Such distribution practices would keep the additional worldwide tax cost to the minimum possible amount in the long run. In summary, the logical results that would have occurred from elimination of deferral for 1976 taking into account foreign withholding taxes (but not deferred corporate income taxes discussed below) is that the U.S. Treasury would have lost $88 million in revenues, foreign governments would have collected up to $416 million, and U.S. company tax costs would have increased by between $206 million and $328 million. The additional tax cost would thus have been between 7% and 11% of the aggregate foreign subsidiary net income of the study companies.

2. *Likely results for all U.S. companies—based on 1976 revenue estimates:* The $206 million U.S. revenue gain calculated for the 88 study companies on the assumption of no behavioral change is 37% of the Treasury's estimated $550 million for all U.S. companies. If the same relationships were to exist under revised distribution assumptions for all U.S. based companies affected by the elimination of deferral and if Treasury's $550 million over-all estimate is correct, the U.S. revenue loss from varying distribution patterns can be estimated. The U.S. Treasury loss from a full distribution for 1976 would have been $235 million. The revenue loss under the 75% distribution assumption would have been $16 million. The total tax cost, paid to foreign governments, would have been between $777 million (under the 75% assumption) and $1.1 billion (under the 100% assumption).

Obviously, it is unrealistic to assume that foreign subsidiary earnings can in fact be fully repatriated to the U.S. or even that distributions could be significantly increased. Most companies need to retain a substantial portion of annual earnings overseas. Moreover, some countries place restrictions on profit distributions. It is not unrealistic, however, to assume that the distribution policy of most companies can accommodate a distribution followed by immediate reinvestment or loan back to the subsidiary in order to avoid long-run double taxation. Companies can be expected to incur at least sufficient foreign withholding taxes to keep long run excess credits to a minimum. Such additional foreign tax payments for 1976 would have been $785 million. It is possible that part of the cash to pay the $785 million or more of additional foreign taxes would have had to come from capital generated internally or borrowed by the U.S. company. In such cases, there might be some adverse effects on the balance of payments.

Based on 1981 Revenue Estimates: If Treasury's $808 million projection for 1981 is correct, and the relationships developed for 1976 remain true in 1981, a full distribution of profits in 1981 will result in a revenue loss of $345 million to the U.S. Treasury. A 75% distribution assumption will result in a revenue loss of $24 million. The total additional foreign tax payments will be between $1.1 billion and $1.6 billion.

In summary, it is most reasonable to expect that if deferral is eliminated companies will be responsive to their shareholders by taking the actions that will minimize their worldwide taxes. The likely result is that the effective foreign tax rate currently being paid on undistributed foreign subsidiary profits will be increased to the U.S. rate by the applicable withholding tax rates (which are presently postponed). The study calculations show that, if this happens for the 88 study companies, the increase in over-all tax cost to the U.S. companies would be equal to or larger than the published estimates, and the revenue would go to foreign governments rather than to the U.S. In short, the U.S. companies and the U.S. government would both be losers, and foreign governments would be the beneficiaries of eliminating deferral. It is logical to conclude that the same results would occur for all U.S. companies in which case the United States will be the loser from elimination of deferral.

V. EFFECT OF CHANGE IN DISTRIBUTION PATTERN AND CURRENT PAYMENT OF DEFERRED FOREIGN TAXES

U.S. law requires that the foreign tax credit and U.S. tax on foreign subsidiary earnings must be calculated based on taxes currently payable by the

subsidiary. Current tax expense reflects the company's actual foreign tax liability taking into account the foreign country's statutory tax rate as reduced by foreign provisions allowing deferral of tax applied to local taxable income. The laws of some countries permit tax payments to be calculated using accounting methods not permitted in the U.S. Examples include immediate expensing or rapid depreciation of certain capital investments, inventory write-downs, etc. In their financial reports to creditors and shareholders, companies often accrue foreign taxes on the full pre-tax profits of the subsidiary irrespective of the fact that part of the tax is not currently payable because one or more of these provisions is applicable.

The difference between taxes currently payable and taxes accrued for financial purposes are deferred taxes; they are not eligible to be claimed as a foreign tax credit until they become payable. The calculations described in the foregoing sections of this report reflect current foreign taxes of the study companies, as required by U.S. tax law.

For the reasons stated at IIIC it is reasonable to anticipate that if the Administration's proposal is enacted companies will avoid timing differences which permit postponement of foreign corporate income taxes for a substantial period of time in order to avoid a very high foreign tax expense in later years which would result in double taxation. It is generally felt that at least part of the amount of such differences is represented by that portion of the annual foreign tax financial statement accruals which represent deferred taxes. Such deferred tax accruals represent an imprecise, but logical, measure of the corporate taxes which are postponed. Our experience indicates that this is a conservative measure of the foreign taxes that could be paid currently by the companies.

In order to quantify the effect of potential behavioral changes of this type, the U.S. Treasury revenues and company tax cost from elimination of deferral were recalculated using the foreign tax provisions of the foreign subsidiaries instead of the current foreign tax expense. The difference between U.S. tax using the foreign tax provision and U.S. tax using current foreign tax expense represents the effect of failure to defer such foreign corporate tax payments. A calculation was made assuming no change in distributions, and again assuming a change in distribution patterns. The calculations showed that if the foreign subsidiaries were to actually incur foreign tax expense equal to the amount accrued for financial reporting purposes, without an increase in distributions, the U.S. tax revenues collected from the 88 study companies for 1976 operations would have been reduced from $206 million to $104 million.

A change in local tax payments with no change in distribution probably is an unreasonable assumption. U.S. companies are likely to respond to the end of deferral by a change in behavior patterns which combines the adjustment of local tax payments and dividend distributions. The calculations made in the study show that if foreign subsidiaries of the study companies had changed their behavior by paying 1976 local corporate income taxes currently and distributing all profits currently the results would have been drastically different than estimated by Treasury. The Treasury would have sustained a revenue loss of $153 million, and the additional foreign tax payments to foreign governments would have been $530 million. The net increase in company tax costs would have been $377 million, which is about 13% of the aggregate foreign subsidiary net profits for the study companies.

It is most likely that in avoiding or minimizing long run double taxation companies will ensure that additional foreign tax payments (withholding and corporate income taxes) are at least sufficient to utilize all available credits currently but also attempt to keep long run additional tax costs to a minimum. In such case, the U.S. Treasury would have suffered a revenue loss in 1976 of $153 million, and the additional foreign tax payments to foreign governments would have been at least $359 million. The net additional cost to the U.S. companies would have been between $206 million, and $377 million.

If the 88 study companies are representative of all U.S. companies and the Treasury's estimates are correct, then the results for all companies under a combined change in behavior patterns (local corporate income tax payments and withholding taxes) can be estimated. If deferral had been eliminated for 1976 and all companies had attempted to minimize their short and long run taxes, the U.S. Treasury would have suffered a revenue loss of $408 million, and the net additional tax costs to U.S. companies would have been between $550 million and $1 billion.

These results can be projected to 1981 using the Treasury's estimated revenue effects. The results from a combined change in behavior will be as follows:

Net revenue loss to Treasury	$599,000,000
Additional foreign tax payments:	
From	$1,400,000,000
To	$2,080,000,000
Net increased in U.S. company tax costs:	
From	$ 808,000,000
To	$1,480,000,000

To the extent the cash needed to pay the foreign government is not available from foreign subsidiary working capital, presumably U.S. companies will have to provide the funds from U.S. working capital.

PARTICIPATING COMPANIES

Abbott Laboraties.
Air Products & Chemicals, Inc.
American Can Company.
American Cyanamid Company.
American Standard, Inc.
AMF, Inc.
Armstrong Cork Company.
Avon Products, Inc.
The Bendix Corporation.
Bickley Furnaces, Inc.
Blue Bell, Inc.
Bristol-Myers Co.
Castle & Cooke, Inc.
Caterpillar Tractor Company.
Celanese Corporation.
Chesebrough-Ponds, Inc.
Chicago Bridge & Iron Company.
Cities Service Oil Co.
Campbell Soup Company.
Clark Equipment Company.
The Continental Group.
Corning Glass Works.
OPC International, Inc.
Crown Zellerbach Corporation.
Cummins Engine Company, Inc.
Dart Industries, Inc.
Deere & Company.
Dow Chemical, U.S.A.
Dresser Industries, Inc.
Eaton Corporation.
Eastman Kodak Company.
The Firestone Tire & Rubber Company.
Foremost-McKesson, Inc.
General Cable Corporation.
General Electric Company.
General Motors Corporation.
General Telephone and Electronics.
The Gillette Company.
The B. F. Goodrich Company.
Goodyear Tire & Rubber Co.
W.R. Grace & Co.
Greyhound Corporation.
Harnischfeger Corporation.
H. J. Heinz Company.
Hercules, Inc.
Hewlett-Packard Company.
Honeywell, Inc.
International Harvester Company.
International Multifoods.
International Paper Company.

PARTICIPATING COMPANIES—Continued

Kennecott Copper Corporation.
Kimberly-Clark Corporation.
Lear-Siegler, Inc.
Eli Lilly and Company.
Loctite Corporation.
Lone Star Industries.
McGraw-Hill, Inc.
McCormick & Co., Inc.
Nabisco, Inc.
National Distillers Products Co.
NL Industries.
Paccar, Inc.
The Parker Pen Company.
Phillips Petroleum Company.
Pitney-Bowes, Inc.
PPG Industries, Inc.
Practor & Gamble International.
Raytheon Company.
Reynolds Metals Company.
R. J. Reynolds Industries, Inc.
Rohm and Haas Company.
Scott Paper Company.
Sherwin-Williams Company.
The Singer Company.
Smith Kline Corporation.
Sonoco Products Company.
Sperry-Rand Corporation.
Standard Oil Company.
Sun Company, Inc.
Texaco, Inc.
Texas-Instruments, Inc.
Textron, Inc.
TRW, Inc.
United States Gypsum Company.
United Technologies Corp.
Upjohn Company.
Weyerhaeuser Company.
Xerox Corporation.

SUMMARY OF RESULTS—ELIMINATION OF DEFERRAL, U.S. TAX RATE OF 48 PERCENT

[In millions]

	Calculated 1976 results for 88 study companies			Projected results for all U.S. companies					
				1976			1981		
Potential behavioral patterns	U.S. Treasury revenue collected (lost)	Additional foreign tax cost to companies	Net increase in company tax cost	U.S. Treasury revenue collected (lost)	Additional foreign tax cost to companies	Net increase in company tax cost	U.S. Treasury revenue collected (lost)	Additional foreign tax cost to companies	Net increase in company tax cost
I. No behavioral change by companies	$206	....	$206	$550	....	$550	$808	....	$808
II. Change in distribution pattern only:									
(a) 100 percent distribution	(88)	$416	328	(235)	$1,110	875	(345)	$1,632	1,287
(b) 75 percent distribution	(6)	291	285	(16)	777	761	(24)	1,141	1,117
III. Current payment of deferred foreign taxes—No change in distribution	104	146	250	278	390	668	408	573	981
IV. Change in distribution pattern and current payment of deferred foreign taxes—100 percent distribution	(153)	530	377	(408)	1,415	1,007	(599)	2,079	1,480

Note: The 100 percent and 75 percent distribution lines reflect the results that would occur if every company followed a 100 percent (or 75 percent) distribution pattern. It is likely that the distribution pattern used by most companies will be the one which minimizes worldwide taxes in the short run and avoids unnecessary excess credits in the long run. The overall distribution percentage in such case would be a mix of individual company patterns which, in the aggregate, is between 75 percent and 100 percent.

ILLUSTRATION OF NEED TO INCUR FOREIGN WITHHOLDING TAXES

This appendix is intended to illustrate how long run double taxation could occur if "deferral" is eliminated and foreign withholding taxes are postponed for a period of time.

An overly simplified factual situation is used so that the consequences can be understood by persons not having substantial technical experience with U.S. tax law. Obviously the worldwide income and tax posture of most companies with foreign subsidiary operations is complex, involving the interaction of many foreign laws with U.S. laws in the context of numerous forms of income. The factual pattern stated below is typical, on a very simplified basis, of the overall results of foreign subsidiary operations, except that normally there are many subsidiaries and additional items of income from the subsidiaries, such as supervision fees, royalties and interest.

Facts

A U.S. corporation wholly owns two foreign subsidiaries, A & B. For the years 1976 through 1985, the subsidiaries each earn $100 per year before foreign taxes. Subsidiary A pays $40 of foreign tax per year, and its dividends are not subject to withholding taxes. Subsidiary B pays $48 of foreign tax per year and each year's net income of $52 is subject to a withholding tax of $8 when distributed. It is assumed that deferral is eliminated for the years 1976 and thereafter.

The following table compares the worldwide tax cost to the U.S. company assuming:

(I) no dividends are paid until 1985 at which time all profits are distributed; and

(II) each year's profits are distributed as earned.

The table shows that by distributing currently, the U.S. company avoids double taxation in the long run (1976–1985) without increasing its annual tax payments.

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	Total
I. No distributions (1976–84)—100 percent in 1985:											
Foreign income taxes:											
Corporate	88	88	88	88	88	88	88	88	88	88	880
Withholding	0	0	0	0	0	0	0	0	0	80	80
U.S. tax:											
Taxable income	200	200	200	200	200	200	200	200	200	200	2,000
Tax before credit (48 percent)	96	96	96	96	96	96	96	96	96	96	
Credit	(88)	(88)	(88)	(88)	(88)	(88)	(88)	(88)	(88)	[1] (112)	
Net U.S. tax	8	8	8	8	8	8	8	8	8	(16)	56
Total worldwide taxes	96	96	96	96	96	96	96	96	96	152	1,016
Worldwide tax rate (percent)	48	48	48	48	48	48	48	48	48	76	51
II. 100 percent distribution annually:											
Foreign income taxes:											
Corporate	88	88	88	88	88	88	88	88	88	88	880
Withholding	8	8	8	8	8	8	8	8	8	8	80
U.S. tax:											
Taxable income	200	200	200	200	200	200	200	200	200	200	2,000
Tax before credit (48 percent)	96	96	96	96	96	96	96	96	96	96	
Credit	(96)	(96)	(96)	(96)	(96)	(96)	(96)	(96)	(96)	(96)	
Net U.S. tax											
Total worldwide taxes	96	96	96	96	96	96	96	96	96	96	960
Worldwide tax rate (percent)	48	48	48	48	48	48	48	48	48	48	48

[1] Foreign tax credit equals $96 allowable against 1985 U.S. tax and an additional $16 as carrybacks to 1973 and 1984. In recognition of the above problem, the administration's proposal would allow an additional year of carryback. Only a 9-year carryback could avoid the problem in the above facts and as a practical matter only an unlimited carryback of credits (or unlimited carryover of limitation) could prevent the above problem for most U.S. companies.

CONSEQUENCES OF ADMINISTRATION'S PROPOSED TAX RATE REDUCTION

The Administration's tax program includes a proposal to reduce the corporate tax rate from 48% to 44%. Whether or not a rate reduction ultimately might be enacted and, if so, by how much, is at best speculative. But if the rate is reduced, elimination of deferral can be expected to produce revenue effects for the U.S. government and tax costs for companies which differ from those occurring at a 48% tax rate.

The purpose of this appendix is to summarize the results that would have occurred for the 88 study companies if the proposed 44% tax rate had been in effect for 1976, and use those amounts to project the results for all companies.

The lower rate consequences were determined using the method of calculation described at III D, except that the applicable U.S. tax rate was 44% instead of 48%. In addition, the reported foreign tax credit limitation of each U.S. company was re-computed. As a result the calculations produce the amount of U.S. Treasury revenues and company tax costs that would have resulted if the companies had been subject to tax at 44% for 1976.

Results for 88 study companies: The aggregate effective foreign tax rate on the undistributed foreign subsidiary income of the 88 study companies is approximately 43%. Taking into account foreign taxes on actual distributions the effective foreign rate is over 44%. As a consequence a tax rate reduction could be expected to eliminate much of the Treasury's revenue gain from eliminating deferral. Furthermore, companies can be expected to respond to elimination of deferral with the same general changes in patterns of distribution and foreign tax payments. At a lower tax rate, however, the magnitude of the response, and the results, might differ. These conclusions are borne out by the results of the 44% tax rate calculations, which are summarized below:

Potential behavioral patterns	U.S. Treasury revenue collected (lost)	Additional foreign tax cost to companies	Net increase in company tax cost
I. No behavioral change by companies	$112	....	$112
II. Change in distribution pattern only:			
(a) 100 percent distribution	(116)	$416	300
(b) 75 percent distribution	(49)	291	242
III. Current payment of deferred foreign taxes—No change in distribution	22	146	168
IV. Change in distribution pattern and current payment of deferred foreign taxes—100 percent distribution	(136)	530	394

Based on 1976 actual results for the study companies the tax rate change would have reduced the Treasury revenue collections from $206 million (at 48 percent) to $112 million (at 44 percent). As can be seen the increased assumed distribution patterns would completely eliminate this gain and create a substantial loss to the Treasury, with foreign governments collecting the additional taxes. It is most reasonable to assume each U.S. company would combine the payment of distributions and foreign corporate income taxes so as to protect it against unnecessary excess taxes in the long run and minimize its current additional tax cost. In such case the Treasury's revenue loss would be $136 million and the foreign governments will collect substantial revenues.

Likely results for all companies: The Treasury has not yet published revenue estimates of eliminating deferral at a 44 percent U.S. tax rate. It is possible, however, to use the study company figures to estimate the results that would have occurred at a 44 percent tax rate to all companies for 1976. Further, it is possible to project the results that will occur to all companies for 1981 at a 44 percent tax rate. These estimates involve the same assumptions that were involved in the 48 percent rate projections described in Sections IV and V of the study, that is, that the study companies as a group are representatives of all U.S. companies and the Treasury revenue estimates are correct. On these assumptions the study results are approximately 87 percent of the results for all U.S. companies affected by the deferral proposal.

If these assumptions are valid, it is reasonable to assume that elimination of deferral for 1976 at a 44 percent tax rate would have produced a U.S. Treasury revenue loss of $363 million. For 1981 the revenue loss for all companies will be $534 million. The foreign governments would collect substantial revenues, however. In 1976, such additional foreign government revenues would have been somewhere between approximately $662 million and $1.4 billion. For 1981, the foreign governments would be likely to collect between approximately $974 million and $2 billion. The 44 percent tax rate results for all U.S. companies for 1976 and 1981 under each of the assumptions calculated in the study are stated in the following table:

SUMMARY OF PROJECTED RESULTS—ELIMINATION OF DEFERRAL EFFECT OF 44-PERCENT U.S. TAX RATE

[In millions]

	Projected results for all U.S. companies					
	1976			1981		
Potential behavioral patterns	U.S. Treasury revenue collected (lost)	Additional foreign tax cost to companies	Net increase in company tax cost	U.S. Treasury revenue collected (lost)	Additional foreign tax cost to companies	Net increase in company tax cost
I. No behavioral change by companies	$299		$299	$440		$440
II. Change in distribution pattern only:						
(a) 100 percent distribution	(310)	$1,110	800	(455)	$1,632	1,177
(b) 75 percent distribution	(131)	777	646	(192)	1,141	949
III. Current payment of deferred foreign taxes—No change in distribution	59	390	449	87	573	660
IV. Change in distribution pattern and current payment of deferred foreign taxes—100 percent distribution	(363)	1,415	1,052	(534)	2,079	1,545

Note: The 100 percent and 75 percent distribution lines reflect the results that would occur if every company followed a 100 percent (or 75 percent) distribution pattern. It is likely that the distribution pattern used by most companies will be the one which minimizes worldwide taxes in the short run and avoids unnecessary excess credits in the long run. The overall percentage in such case would be a mix of individual company patterns.

NATIONAL ASSOCIATION OF MANUFACTURERS/EMERGENCY COMMITTEE FOR AMERICAN TRADE TAX DEFERRAL STUDY

Name of company ____________ Fiscal year end ____________

Co. No.	Country of incorporation	Subsidiary parent		Pretax profits	Translation gain/loss L. T. debt	Current foreign tax expense			Foreign tax provision (total only)	Actual dividends paid from current year profits	Subpart F income and section 956 dividend	Dividends received from lower-tier CFC's	Explanation of substantial tax rate variance
						On dividends from lower-tier CFC's		On all other income					
		Co. No.	Percent owned			With-holding tax	Income tax						
(A)	(B)	(C)	(D)	(E)	(F)	G(1)	G(2)	G(3)	(H)	(I)	(J)	(K)	(L)
1													
2													
3													
4													
5													
6													
7													
8													
9													

NATIONAL ASSOCIATION OF MANUFACTURERS/EMERGENCY COMMITTEE FOR AMERICAN TRADE TAX DEFERRAL STUDY—Continued

Name of company ______ Fiscal year end ______

		Subsidiary parent				Current foreign tax expense							
						On dividends from lower-tier CFC's							
Co. No.	Country of incorporation	Co. No.	Percent owned	Pretax profits	Translation gain/loss L. T. debt	With-holding tax	Income tax	On all other income	Foreign tax provision (total only)	Actual dividends paid from current year profits	Subpart F income and section 956 dividend	Dividends received from lower-tier CFC's	Explanation of substantial tax rate variance
(A)	(B)	(C)	(D)	(E)	(F)	G(1)	G(2)	G(3)	(H)	(I)	(J)	(K)	(L)
10													
11													
12													
13													
14													
15													
16													
17													
18													

NATIONAL ASSOCIATION OF MANUFACTURERS/EMERGENCY COMMITTEE FOR AMERICAN TRADE TAX DEFERRAL STUDY

	Name of company	Fiscal year end

U.S. company information requested from form 1118:[1]
- Total foreign taxes (including any carryover) (schedule B, pt. II, line 5)........
- Carryback or carryover to year of credit (schedule B, pt. II, line 4)........
- Limitation (schedule B, pt. II, line 14)........

[1] Consolidated data is requested. U.S. companies not filing a consolidated U.S. tax return may submit either (1) the combined amount of foreign taxes, carryover, and limitation for all companies as if a consolidated return had been filed or (2) separate company information (with the names of the U.S. subsidiaries deleted).

Additional information: Please describe situations in which legal restrictions or exchange controls would prevent full distribution of profits by 1 or more CFC's, or would result in penalty-type taxes (such as in certain South America countries).

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....

....

Note: Line references are to form 118 (rev. 1-77). If a different version of this form was filed, the appropriate line numbers may vary.

DEFINITIONS

(A) COMPANY NO.

For our computer program calculations each company must be assigned a number. We will assign number "1" to the U.S. affiliated group. Each foreign corporation should also be given a number. The simpliest method of doing this would be to number the foreign corporations consecutively (2, 3, 4, etc) down the page, although any numerical designation is acceptable as long as no number is used for more than one company. All foreign subsidiaries that are controlled foreign corporations should be included.

(B) COUNTRY OF INCORPORATION

Designate the country of incorporation. If more than one subsidiary is incorporated in the same foreign country, each should be reflected on a separate line. It is not necessary to indicate the name of the company as long as each subsidiary is given a separate company number.

(C) COMPANY NO. OF SUBSIDIARY'S PARENT

If the foreign corporation is owned by another foreign subsidiary the company number of that other foreign parent corporation should be designated. This information will be used to compute the effect of the distributions of lower tier profits of the U.S. If the foreign corporation is owned by the U.S. parent (or one of its U.S. affiliates, the entry in this column should be "1". If the ownership is split between two or more affiliates, the separate ownership interest should be reflected as a separate subsidiary. The entire profits, taxes, etc. should be included in columns E–J (as described below) notwithstanding ownership of less than 100%.

(D) OWNERSHIP PERCENTAGE

The percentage of stock owned should be designated in this column (i.e., 100%, 51%). In the case of ownership that is split between more than one affiliate, the separate ownership interest should be reflected as a separate subsidiary. The entire profits, taxes, etc. should be included in columns E–J (as described below) notwithstanding ownership of less than 100%

(E) PRE-TAX PROFITS

This column should reflect each foreign subsidiary's earnings and profits before tax in U.S. dollars as determined in accordance with the Section 964 regulations. The entire earnings and profits of the company should be included regardless of the percentage owned. If earnings and profits have not been determined under Section 964, pre-tax book income should be used. In this case (only) the translation gain/loss information should be completed on Line F. Deficits incurred by loss companies should be included.

(F) TRANSLATION GAIN OR LOSS ATTRIBUTABLE TO LONG TERM DEBT (IF ANY)

This column should reflect exchange gain or loss, if any, resulting from translation of *long term debt* (only). Under FASB 8, such gain or loss is included in net income for financial reporting purposes but for income tax purposes it is not included. This adjustment is being included because it sometimes is substantial and could be an adjustment affecting the outcome of the study. If the amount is immaterial, it may be disregarded, in which case the entry in this column should be "nominal". This line should be used only if pre-tax book income is used for pre-tax profits.

(G) CURRENT FOREIGN TAX EXPENSE

The tax figure should reflect creditable foreign income taxes currently payable. Note that the current tax expense will differ from the subsidiary's provision for income taxes for the year in that the current tax does not include deferred taxes. If the exact amount of current taxes is not known the current tax expense may be estimated as accurately as possible.

Foreign taxes, if any, incurred by loss companies should be included.

If the subsidiary received dividends from one or more lower tier CFC's, lines G1 and G2 should be used in addition to G3. If not, only G3 will be applicable.

G(1) This column should include taxes that have been withheld on dividends received from lower tier CFC's. Only the total of such taxes should be provided; it is *not* necessary to provide a further breakdown if dividends have been received from more than one lower tier company.

G(2) This column should include the corporate profits or income tax (other than withholding tax), if any, that the subsidiary paid on dividends received from lower tier CFC's (total only).

G(3) This column should include the tax that the subsidiary paid on corporate profits other than dividends received from lower tier CFC's.

(H) TOTAL FOREIGN TAX PROVISION

This column should be the subsidiary's provision for creditable income taxes for the year. Provision for tax refunds should be indicated by brackets ( ). It is not necessary to break down this amount between taxes on dividends and other income.

(I) DIVIDENDS FROM CURRENT YEAR PROFITS

This column should reflect total dividends actually paid in cash or in property from current year profits by the subsidiary.

(J) SUBPART F INCOME OR § 956 DIVIDENDS

This column should reflect the total Subpart F income or investment in U.S. property which is taxable for the year. Companies that elected to exclude Subpart F income under § 963 for 1976 should include in this column any income that would be taxable Subpart F income based on the law applicable to 1977 and subsequent years.

(K) DIVIDENDS RECEIEVED FROM LOWER-TIER CFC'S

This column should include total dividends actually received in cash or in property from lower tier CFC's. This amount will also be included in pre-tax profits (Column E) and may also be Subpart F income (Column J).

(L) EXPLANATION OF SUBSTANTIAL TAX RATE VARIANCES

This column should be used to briefly explain significant variations between the current foreign tax expense or tax provision and the application of the statutory rate to pre-tax profits. This column should only be completed when there is a substantial distortion of tax expense. We will use this information to keep the number of questions which have to be resolved to a minimum. An example of an item which may cause such a distortion is a net operating loss carryover.

The CHAIRMAN. Next, we will hear from Mr. George H. Lawrence who we saved for last, speaking for the American Gas Association.

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, AMERICAN GAS ASSOCIATION

Mr. LAWRENCE. Thank you, Mr. Chairman and Senator Danforth. I am George Lawrence, president of the American Gas Association and I am accompanied by Michael Zimmer, who is our director of legislative and regulatory policy development, which is a euphemism for our tax lawyer.

We will be very brief, Mr. Chairman, in our recommendations and our support of the tax bill that has been passed by the House and sent over.

As a preface, I would like to say as far as energy utilities are concerned, the tax incentives that we seek and that we support are indeed important. In the case of the natural gas industry, by way of reminder, we provide 30 percent of the total U.S. energy requirements, consisting of 55 percent of all of the energy used in residential and commercial establishments, and 40 percent of the energy used by U.S. industry and U.S. agriculture.

We think, Mr. Chairman, that it is very realistic that the gas industry can be providing that same significant proportion of the total energy mix well into the next century. As we do that, we will find ourselves moving to an industry that is more capital intensive, with emphasis on supplemental supplies, instead of conventional natural gas supplies. We will begin to focus more and more on such supplementals as gas from Alaska, coal gassification, LNG, et cetera. As a matter of fact, with increased emphasis on these supplemental gas supplies, we estimate that the anticipated investment between now and the year 2000 will total some $204 billion (in 1977 dollars), which is some four times the cumulative investment we have of approximately $50 billion in the gas transmission and distribution industry to date.

With that by way of a preface, Mr. Chairman, I shall briefly present our recommendations. No. 1, the gas industry strongly supports the provisions of H.R. 13511 which make the 10-percent investment tax credit permanent while raising the income tax liability limitation on the credit to 90 percent.

We also support the extension of the credit to industry structures instead of only to machinery and equipment.

Second, we do indeed support the corporate tax rate reduction, while stressing that the benefits generated by this tax rate reduction should remain available to regulated utilities.

However, since most States would tend to flow through such tax relief in the rate proceedings to the utilities' customers, the reduction would be very temporary, in most instances, to the energy utility industry.

Because of that fact, we think special consideration should be given to additional tax incentives for energy utilities; namely, increasing the rate of the investment credit from 10 percent to 12 percent. This has been an issue before this committee for several years.

Third, creating a new tax classification for energy property, permitting faster tax writeoffs for these facilities.

Fourth, providing a tax deferral for dividends reinvested into dividend reinvestment programs.

We support the capital gains tax relief provided in H.R. 13511 on its own merits. We emphasize that there should be no trade-offs associated with other capital formation incentives, such as the investment tax credit.

We believe that the relief provided in H.R. 13511 is a long-needed step in the right direction as an aid to capital formation.

We would also ask this committee's special consideration for an additional issue of concern to the regulated gas industry. In particular, that is to confirm by statute the longstanding rules that contributions in aid of construction do not constitute gross income to regulated gas and electric utilities.

This is the same equitable tax treatment presently afforded water and sewage utilities.

S. 3176, introduced by Senator Laxalt, would accomplish this goal, and we urge this committee to seriously consider this bill during markup. The House Ways and Means Subcommittee on Miscellaneous Revenue Measures has approved comparable legislation (H.R. 11741) by an unanimous vote of 6 to 0.

We do, indeed, recognize the need for tax policy to reflect tax incentives for exploration and development, especially focusing on new energy facilities. We certainly know of your longstanding concern in that direction, Mr. Chairman, and we applaud that.

We thank you for the opportunity to appear here today.

The CHAIRMAN. Thanks you very much.

I am going to ask that your full statement, along with these charts, appear in the record.

Senator Danforth?

Senator DANFORTH. No questions.

The CHAIRMAN. We appreciate your very good statement today. Thank you.

Mr. LAWRENCE. Thank you.

[The prepared statement of Mr. Lawrence follows:]

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, AMERICAN GAS ASSOCIATION, BEFORE THE SENATE FINANCE COMMITTEE ON THE REVENUE ACT OF 1978 (H.R. 13511), AUGUST 21, 1978

Mr. Chairman and members of the committee: On behalf of the American Gas Association, which represents some 300 natural gas distribution and transmission companies serving over 160 million U.S. consumers, I am pleased to provide our industry's views on the Administration's proposed 1978 tax reduction and tax reform program and the Revenue Act of 1978.

Our nation's economic growth and the growth of the gas industry rests to some degree upon tax policy matters currently before this Committee. I would like to initially outline where we now stand as an industry, and the direction we could head under a conducive regulatory and tax policy climate.

Natural gas currently provides almost 30 percent of total U.S. energy supplies. Gas is used in about 55 percent of all residences and commercial establishments in our nation, and provides some 40 percent of the energy consumed by U.S. industry, and about the same significant portion of energy used by U.S. agriculture. More gas is produced domestically than any other fuel and gas provides three times as much end-use energy to consumers as electricity.

Even though the U.S. Geological Survey and other sources estimate there are at least another 35 to 60 years of remaining conventional U.S. gas resources at present annual consumption rates (see Attachment 1), domestic gas is becoming

more difficult and expensive to find and produce. Even with more realistic federal regulatory policies which would permit deregulation of new gas to be priced at levels equivalent to alternative fuels, it is clear that beyond the early 1990's domestic production of conventional lower-48 state natural gas will slowly begin to decline. This decline, coupled with continued growth in total U.S. energy demand (even at rates as low as 2 to 3 percent per year), means that substantial increments of energy will be needed to meet our nation's future energy requirements. This was dramatized by the fact that the President's 1977 National Energy Plan (NEP), which contained ambitious energy conservation goals, assumed that energy consumption will increase by 25 percent between now and 1985.

As conventional domestic oil and gas production eventually declines, the burden of meeting this growth in U.S. energy requirements will fall upon three alternatives—increased oil imports, electricity generated from coal or nuclear power, and nonconventional energy sources including supplemental and unconventional gas. I think we can all agree that increased oil imports are an unacceptable solution to this problem. Our nation's continuing growth in oil imports has steadily aggravated our foreign balance of payments, has contributed substantially to the domestic rate of inflation, and has caused a decline in confidence in the U.S. dollar abroad.

The solution that was proposed by the Administration in its NEP was to rely substantially on the second alternative, that is, on electricity generated mostly by coal and nuclear power. In fact, this almost total reliance on electricity for new energy supplies was manifested in the President's NEP by projection of a 48-percent growth in electric production between 1976 and 1985, with virtually no growth projected for natural or supplemental gas production. Yet, on a comparative basis, these sources of gas could provide energy to the residential end-user at less than one-half the cost and at less than one-third the capital investment.

The maintenance of artificially low new natural gas prices and the lack of any positive tax or other incentives for accelerating the introduction of new gas sources will make such gloomy gas projections a self-fulfilling prophecy. Our industry does not subscribe to this view of the future and we believe the overall public interest would not be served from the perspective of consumer impact, the nation's economy, resource efficiency, and environmental protection. Further, we believe that with proper federal tax incentives for capital formation and a positive regulatory environment, gas supplies can actually grow from the present 20 quads per year to over 30 quads by the year 2000, permitting gas to continue supplying some 30 percent of total U.S. energy requirements (Attachment 2).

CAPITAL REQUIREMENTS OF THE NATURAL GAS INDUSTRY

Although a national energy plan is necessary to provide a positive direction for efficient and judicious use of valuable energy resources, it is just as necessary for this nation to formulate tax policy that will permit formation of sufficient capital to finance the development of new gas resources to meet growing national energy requirements. Even though reduced earnings and lower levels of investment capital have adversely affected U.S. business in general, these problems have a more severe impact on regulated industries such as the natural gas industry whose rates of return are limited to relatively modest levels.

As an industry, we know that we must engage in a massive capital expenditure program during the next ten years to develop necessary supplemental sources of gas, which are in general, more capital intensive than traditional pipeline and utility construction projects. We anticipate requirements for capital expenditures associated with supplemental gas supply projects to total $97 billion (1977 dollars) between now and the end of this century. This figure is almost twice the current level of capital investment in the gas industry which now stands at $52 billion. If we add these capital requirements for supplemental gas supplies to exploration and development investments by the gas utility industry as well as the more traditional requirements for pipeline and distribution system maintenance and construction, the projections quadruple the current levels of invested capital. By the end of this century, an estimated $204 billion (1977 dollars) of additional investment in the gas industry will be required .(See Attachment 3)

Based on these projections, the annual capital investment of the U.S. gas utility industry is expected to rise from 1.9 percent of U.S. gross annual private investment in 1976 to 3 percent in the 1990's. The ability of the U.S. gas utility industry

to attract this level of investment will require a legislative and regulatory environment that favors growth of the industry and a level of return on investment which is competitive with other opportunities in the capital markets. Tax policy will play a significant role in determining the ability of the natural gas utility industry to raise the large amounts of capital necessary to finance such vital projects as the Northwest Alaskan Pipeline ($10 billion), coal gasification plants (at $1.4 billion each (and large LNG projects ($2 billion for facilities and ships). Federal tax policy must be developed with cognizance of the long lead times associated with construction of such large projects, and the unique problems the regulated natural gas utility industry faces in its efforts to secure sufficient capital to finance these projects.

Insufficient capital recovery allowances: Rate structures typically devised for regulated natural gas utilities focus retrospectively on plant investment already in place rather than looking ahead to the projected cost of new and necessary facilities to meet future projected gas demand. As the delays of extensive regulation increase, and as the lead times for new gas supply projects grew coupled with severe inflationary increases in construction costs, depreciation provided in current gas utility rate structures has proven grossly inadequate. Current depreciation allowances have been insufficient in providing funds for the replacement of facilities at current prices.

Lower earnings than permitted in ratemaking proceedings: It is a function of regulatory authorities to permit a utility to earn an adequate rate of return on its investment to ensure its financial viability and to permit the company to attract new capital. However, because of the lengthy ratemaking process, rates that are established with those concepts in mind are often based on cost data which has become hopelessly deficient due to inflation. Utility rates inevitably provide actual returns that are far less than adequate. This result causes dissatisfaction among equity investors with a resulting increase in the cost of equity capital to the utility.

Financing requirements: During 1976, the percentage of construction expenditures financed by internal and equity sources decreased from 1975 levels of 53.8% and 11.9% respectively, to 43.4% and 9.8%. During this same year, the percentage of such expenditures financed by debt issues showed dramatic increases from 1975 levels of 34.3% to 46.8%. This undesirable trend indicates the need for responsive tax policy reform to stimulate internal and equity sources of capital formation to ensure that the capital requirements of the gas industry during the next decade are met.

COMPARISON OF GAS INDUSTRY CAPITAL REQUIREMENTS WITH THOSE OF OTHER ENERGY ALTERNATIVES

Progressive tax policy, in terms of meeting the capital requirements of all energy sectors in the economy, should also reflect a detailed assessment of the comparative advantages of gas energy vs. other energy alternatives. Such an assessment indicates the substantial comparative benefits of gas from a capital requirement and consumer cost perspective.

The President's supply-side strategy in the NEP projected an additional 3.1 quads per year of electricity delivered to the end-user in 1985. The capital requirements and consumer costs of generating this additional 3.1 quads per year of electricity are far greater than developing and using 4.8 quads per year of natural and supplemental gas, an equivalent amount of useful energy considering end-use efficiencies. The unrealistically large electric growth rates in the NEP would involve the completion of almost 260 new coal-fired electric plants and over 100 new nuclear power plants in the next eight years alone. If this proposed electric growth were replaced with additional natural and supplemental gas, more than $112 billion could be saved in domestic capital investment and American consumers would save over $25 billion annually in their energy bills by 1985. (See Attachment 4)

A.G.A. aso emphasizes that in general, domestic energy supply and utilization systems based on gaseous fuels require substantially less (from 36 to 50%) new capital investment for all major end-use energy markets than equivalent nuclear, coal and solar electric systems or synthetic liquids-based systems. On a national average basis, supplying added quantities of gaseous fuel from domestic resources for direct use in residential and commercial space heating will require 18 to 90% less capital than electrification for the same amount of useful energy. Finally, supplementing priority industrial requirements (e.g. process, feedstock,

etc.) with domestic gaseous and liquid fuels is generally one-third as capital intensive as developing new supplies of electricity (See Attachment 5)

Providing incentives for accelerating additional gas supplies also makes sense when comparing consumer costs of natural gas with other energy alternatives. While wellhead prices of natural gas have increased at an annual rate of about 8.9% since 1960, residential natural gas prices have risen at only 4.4% per year in the same period. Commercial gas prices have increased at an annual rate of 4.8% during the same period, whereas industrial gas prices have risen at an annual rate of 9.1%. (See Attachment 6) Since 1950 natural gas has been the least expensive fuel and even now its price on a national average basis is only 66% of the price of oil and 20% of the price of electricity, on a delivered basis.

SUMMARY OF GAS INDUSTRY POSITIONS AND RECOMMENDATIONS

Recognizing the inherent benefits of natural gas and supplemental gas vs. other energy alternatives and stressing the capital requirements necessary to continue providing this premium fuel, the A.G.A. emphasizes the following positions and recommendations concerning the Administration's 1978 tax reduction and tax reform proposals and the Revenue Act of 1978:

1. The gas industry strongly supports the provisions of H.R. 13511 that make the 10% investment tax credit permanent while raising the income tax liability limitation on the credit to 90%. We also support the Administration recommendation that the investment tax credit be extended to industrial structures to improve the pace of capital recovery for necessary construction and modernization of gas industry facilities.

2. The A.G.A. supports corporate tax rate reductions as the most generally equitable and understandable form of business tax cuts. However, for this tax cut to be an effective tool for capital generation in the regulated utility industry, the benefits it generates must remain available to the utility company. Therefore, we recommend that the Congress express its intent that the benefits of the rate reduction not be flowed through to utility customers.

Because corporate tax rate reductions may not provide a direct capital formation to regulated utilities, without some protection from flow through, A.G.A. urges this Committee to consider one of several alternatives as additional and more readily applicable incentives for such utilities:

(a) Increase the investment tax credit rate from 10% to 12% on a permanent basis for regulated utilities, while making it clear that Congress is making the investment tax credit available only if the utility can retain it for further capital expansion; or

(b) Create a new tax classification for certain "energy property," that is, property used in the search for and development and subsequent operation of new energy sources such as coal gasification, SNG plants and new pipelines. This should provide at the gas utility's binding election: (i) a depreciable life of 8–10 years for such property with an increased investment tax credit rate of 20%, with normalization required, or (ii) a five-year amortization of the cost of such property, with no investment credit, but with normalization required; or

(c) Provide tax referral for dividends reinvested into dividend reinvestment programs.

3. The gas industry also supports the capital gains tax relief provided in H.R. 13511 on its own merits.

A.G.A. also recommends the following proposals for this Committee's consideration during its deliberations on this legislation:

1. The A.G.A. recommends that Section 118 of the Internal Revenue Code should be amended to specifically confirm the long-standing rule that contributions in aid of construction and amounts similarly treated, termed highway relocation reimbursements do not constitute gross income to regulated gas and electric utilities. This is the same tax treatment presently accorded water and sewerage disposal companies.

2. A.G.A. urges specific Congressional recognition of the need for tax policy to reflect exploration, development and energy facilities tax incentives by providing that: (a) any surcharge revenue collected from customers under appropriate regulatory safeguards to be used exclusively for the exploration for, and development and transportation of, new sources of natural gas should be excluded from gross income of the gas company, and that (b) the costs of geological and geophysical work, feasibility and environmental studies, certification, start-up programs and other pre-operating expenses (including training costs) related

to the establishment of new domestic energy facilities should be deductible as incurred.

3. Finally, the gas industry urges the Congress to consider amending Section 263(a)(1) of the Internal Revenue Code to expressly confirm the long-standing practice of deducting taxes, interest, health and accident insurance, pension costs, vacation pay, general overhead, and other overhead expenses and not treat them as capital expenditures.

At this point, we would like to offer a more detailed explanation of these gas industry positions and recommendations.

INVESTMENT TAX CREDIT

The A.G.A. strongly supported the Administration's proposals concerning the investment tax credit as the most direct and effective means to provide stimulus to capital investment in gas industry projects. H.R. 13511 embraces most of the Administration's proposals regarding the investment tax credit. However, it only expands the credit to include rehabilitation expenditures for existing industrial and commercial buildings, and not new buildings.

As we have previously mentioned, legislative and regulatory assistance is necessary to assure the financing of major gas industry supply projects, such as coal gasification plants and LNG facilities. The Administration's investment tax credit proposals and the provisions in H.R. 13511 conform in many respects to previous recommendations of the A.G.A. during the last session of Congress. They should be promptly enacted into law.

We particularly commend the President and the House of Representatives for recognizing the importance of making the investment tax credit permanent. Unfortunately, in the past the investment tax credit has been an "on-again, off-again" incentive, thereby making it extremely difficult for the gas industry, as well as other industries, to formulate their capital outlay plans on a rational, orderly basis with the knowledge that the credit will continue to be available. For example, under current law, property acquired or placed in service after December 31, 1980, would be subject to only a 7 pecent investment tax credit (4 percent in the case of public utilities) if the current 10% credit is not made permanent.

For the investment credit to achieve maximum effect, it must be made a permanent part of our tax laws in the same manner as the depreciation deduction. Only with the stability of a permanent credit can the gas industry and the financial community plan and carry out the capital expenditure programs that are so necessary to deal with the serious natural gas supply problem confronting our country.

Merely making the 10% investment tax credit permanent, however, will not in itself provide a meaningful benefit and stimulus to major and very important segments of the natural gas industry. Without a concomitant reduction in the restrictive limitation on availability to use the permanent investment tax credit to offset tax liability, these segments of the industry will achieve only minimal benefits.

Under current law, certain public utilities are now allowed the benefit of the investment credit to the extent of 80 percent of their tax liability in 1978; this allowance then decreases 10 percentage points a year to the generally applicable 50 percent limitation in 1981. This increased availability of the credit to offset tax liability has been highly beneficial to the electric industry, but has benefited only a limited segment of the gas industry—those companies in the local distribution segment of the industry. Under current law for purposes of the less restrictive investment credit limitation, the term "public utilities" does not include utilities engaged in the transportation of gas by pipeline or those engaged in the development of supplemental sources of gas supplies, such as those engaged in the production of synthetic gas from coal and liquid hydrocarbons as well as those engaged in the liquefaction, transportation and regasification of liquefied natural gas. Thus, these companies are excluded from the benefits of the less restrictive limitation on availability to use the investment credit to offset tax liability.

These excluded segments of the gas industry are the very segments which have to raise the greatest amounts of capital in the foreseeable future. Since the critical problem of the gas industry is to finance new gas supply facilities, they must not be excluded from the benefits of the less favorable investment credit limitation. Distribution, pipeline, and gas supply facilities all are essential to continued gas service.

For these reasons, A.G.A. vigorously endorsed the Administration proposal and supported the provisions of H.R. 13511 which allow all industries to use the investment tax credit to offset up to 90% of tax liability. This change establishing a uniform percentage limitation on the use of the credit will strenghen the incentive provided by the credit and simplify its administration. House action on this issue conforms with the spirit of A.G.A. recommendations in the past which urged elimination of the distinction in our tax laws based on the type of gas utility and availability of increased benefits on the same basis to all gas utilities.

A.G.A. also endorses the President's proposals to extend the stimulus provided by the investment credit to investments in industrial structures. This feature of the business tax program will eliminate the bias under current law against balanced expansion and eliminate the administrative complexities associated with distinguishing between equipment and machinery (which currently qualifies for the tax credit) and buildings and their structural components (which do not currently qualify). The House has only provided the benefit of the credit to rehabilitation expenditures for existing industrial and commercial buildings. We respectfully urge this Committee to provide the credit for new buildings as well.

However, A.G.A. stresses that the legislative history of this proposed change must offer sufficient guidance concerning the definition of an "industrial structure" to ensure that implementing Treasury regulations do not effectively preclude meritorious capital projects. This is important since the Treasury has already indicated that this change will generally be accomplished by deleting the provision of present law that specifically excludes a building and its structural components from the definition of property eligible for the investment credit.

Finally, if the investment tax credit is to achieve its purpose for natural gas utilities, these utilities must be allowed to retain, as non-regulated industries can retain, the entire amount of the investment credit. Utilities must not be required to flow through directly or indirectly any part of the benefits of the credit to their customers in the form of lower rates. Congress has already taken a partial step in this direction by providing that the benefits of the investment credit ESOP (which are intended to benefit the employees of a corporation) would not be available if the credit is flowed through to ratepayers. This policy of discouraging regulatory agencies from flowing through the tax benefits of the investment credit to the ratepayer should now be extended, as the A.G.A. has frequently urged in the past, to the entire investment credit.

The credit is designed to stimulate business investment and to assist the natural gas industry in meeting the capital expenditure requirements it faces. The benefits of the credit should be retained within the companies for further capital expansion which is the primary purpose for which the credit was created. These objectives are frustrated if regulatory commissions are allowed to pass on the increased cash flow from the investment credit to customers through a reduction of utility rates. Also, flow-through of the credit would encourage waste and frustrate current government efforts to conserve valuable energy resources.

Accordingly, Congress should specifically provide that the investment credit will not be available to a utility if its regulatory agency requires it to flow-through in any manner or form the tax benefits of the investment credit to the ratepayers. Furthermore, there should be no options or elections provided for the utilities to flow-through these benefits. The existence of any option places the utility in an extremely difficult position. Pressure on utilities by regulatory agencies to make elections which would lower consumer rates can be subtle, but very intense. In many cases, the practical result of the existence of an option or election would be forced flow-through of the benefits of the credit to ratepayers, thereby frustrating and nullifying the purpose and objectives of the credit.

CORPORATE TAX RATE REDUCTIONS AND OTHER APPROPRIATE CAPITAL FORMATION ALTERNATIVES

The proposed corporate tax rate reduction is a significant first step toward increasing capital formation, primarily for non-regulated corporations. Such a reduction would increase the amounts of aftertax profits available for reinvestment and increased dividend distributions by these companies.

However, corporate tax rate reductions will provide little effective capital formation stimulus for regulated natural gas utilities because the benefits would be lost throv.gh rate-making treatment of the tax reductions. For the regulated natural gas industry, the two major objectives of this Administration proposal and feature of H.R. 13511, in terms of promoting long-term capital formation and of maintaining the current level of economic recovery, would be minimal.

Corporate tax rate reductions would effectively lower customer rates for service because of the impact of the tax reduction on the utility's cost of service. This loss of the specific benefits of this proposal would effectively deprive the gas utility of the favorable impacts on corporate cash flow and higher after tax earnings which would lead to increased dividends to shareholders or more rapid anticipated growth in share prices. Thus, this proposal could have a primarily neutral impact on investment planning by regulated natural gas utilities unless the Congress expressed the intent that the benefits of the tax cut not be flowed through to utility customers.

Although corporate tax rate reductions are the most generally equitable and understandable form of business tax cuts, they are the least efficient way to provide direct stimulus to capital formation. Capital formation really is a merely indirect or ancillary impact of the proposal, and not as specifically directed as the investment tax credit changes proposed by the Administration and approved by the House of Representatives.

Since corporate tax rate reductions may not provide direct relief to regulated gas utilities without some protection from flow through, the Committee may wish to consider the relative merits of providing tax relief to regulated utilities through one of several different alternatives, as additional and more readily applicable incentives for such utilities.

Increase the investment tax credit rate from 10 percent to 12 percent on a permanent basis. This additional percentage increase in the credit would provide the direct capital formation stimulus for regulated utilities sought by the Administration proposal and House provisions to reduce corporate tax rates.

A new tax classification for qualified energy property (that is, property used in the search for or development and subsequent operation of new energy sources—such as coal gasification and other SNG plants and new pipelines) should be created. This new classification would provide at the taxpayer's binding election:

A depreciable life of 8–10 years for the qualified facility with an increased investment credit rate of 20 percent, with normalization required, or

A five-year amortization of the cost of the energy facility, with no investment credit, but with normalization required.

This would be comparable to the emergency facilities amortization concept used in World War II. Under current law, there is no special tax classification for energy property. However, these are special amortization provisions in the Internal Revenue Code covering certain facilities and other properties having an important national interest. These Code provisions permit amortization over a shorter period of time, regardless of useful life. Some examples include pollution control facilities (Section 169); railroad rolling stock and right-of-way investments (Sections 184–185); and on-the-job training and child care centers (Section 188).

This proposal would enhance development of these urgently needed projects by permitting faster write-offs to recover the significant investments in these facilities. Maximum flexibility is assured through the election approach incorporated in this proposal. A new tax classification for energy property provides important national benefits as well. It recognizes an important national interest in development of these energy facilities and the contributions they can make to alleviate supply shortfalls. It also promotes efficient use of the present one million mile natural gas pipeline and distribution system which is less expensive than creating new transportation systems or using the present facilities inefficiently at less than full capacity.

Provide tax relief to dividend reinvestment programs of regulated public utilities. Federal taxes could be defered when shareholders reinvest dividends in original issue common stock providing a direct and mportant source of essential equity capital for such utilities which would not be readily available under the Administration's corporate rate reduction proposals.

Under present tax law, a dividend reinvestment plan participant must pay Federal income taxes currently on the value of the stock received. A modification that would permit deferral of taxation until the stock were sold or disposed of would clearly provide a major incentive to broadened participation in such programs. This proposal has received some Congressional consideration this session in the House Ways and Means Committee. Congressman Pickle (D-TX) has introduced H.R. 12182 which has 12 co-sponsors, and a companion Senate bill is expected soon. A.G.A. supports the Pickle bill as an appropriate vehicle for providing necessary tax relief to dividend reinvestment plans.

A.G.A. stresses that it is timely to renew consideration of this proposal which is totally consistent with the Congressional focus on reducing taxes and stimulating the economy. It also would provide a direct contribution to capital forma-

tion where it is seriously needed and somewhat reduce the impact of double taxation of corporate dividends—two widely supported national objectives.

CAPITAL GAINS

A.G.A. supports the capital gain tax relief provided in H.R. 13511 on its own merits, since this approach has emerged as the primary thrust of capital formation legislation during this session of Congress. We emphasize that there should be no trade-offs associated with other key capital formation incentives, such as the investment tax credit.

Independent studies have shown that capital gains tax relief could increase stock market prices substantially, generating additional sources of capital formation for U.S. industries. Although the gas industry historically has not experienced substantial appreciation in the prices of its equity issues, the benefits of a positive investment environment for all industries generated by the capital gains tax provisions of H.R. 13511 would accrue to the gas industry as well.

CONTRIBUTIONS IN AID OF CONSTRUCTION

A.G.A. stresses that one of the most important tax policy reform issues for the gas industry that the Congress can clarify this session is the tax treatment of contributions in aid of construction. We urgently recommend that Section 118 of the Internal Revenue Code be amended to specifically confirm the long-standing rule that contributions in aid of construction and amounts similarly treated, termed highway relocation reimbursements, do not constitute gross income to regulated gas and electric utilities. These amounts collected by gas and elecrtic utilities should be treated as contributions to capital in the same manner as they are treated for water and sewerage disposal utilities.

In general, contributions to capital of a corporation are not income and, therefore, are not taxable. The Tax Reform Act of 1976 confirmed this treatment for regulated public utilities providing water or sewerage disposal services as long as the contributions or property purchased with these amounts are not included in the utility's rate base for ratemaking purposes. However, Congress failed to confirm the tax treatment of contributions in aid of construction for gas and electric utilities. It now appears that the Internal Revenue Service will not treat these contributions to gas and electric utilities as contributions to capital in the same manner as water and sewerage disposal utilities.

Congressional interest in this issue has carried over into the 95th Congress. Congressman Lederer(D-PA)has introduced a bill, H.R. 11741 with 14 co-sponsors, to clarify tax treatment of these amounts; and the House Ways and Means Subcommittee on Miscellaneous Revenue Measures has approved this measure recently by a unanimous vote of 6–0. Senator Laxalt has also introduced comparable legislation in the Senate (S. 3176) which has been referred to this Committee for consideration.

These contributions in aid of construction are payments by the customers of a public utility for all or a portion of specific construction costs incurred to extend service beyond a prescribed distance established by the applicable regulatory commission. Typically, they are payments made to extend utility service long distances or into isolated areas where use of utility's own funds would not be justified from the standpoint of return on investment. If the facilities were built without receipt of any contributions in aid of construction, the cost of such facilities would be borne in part by customers who receive no service or benefits from them.

Reimbursements utilities receive from government agencies for costs in relocating their facilities to accommodate governmental projects also have traditionally been excluded from gross income in a manner similar to the treatment of contributions in aid of construction.

It is important to note that contributions in aid of construction are not so-called "customer connection or reconnection fees", i.e., payments made by a customer to have utility service turned on or off or to have service supplied within normal prescribed limits. These amounts have historically been included in the income of utilities and taxed. No change in the treatment of connection fees would be made by this proposed clarification, therefore, it results in no revenue loss to the U.S. Treasury.

Failure to treat these payments as contributions to capital will create a serious inequity between water and sewerage disposal utilities and gas and electric utilities. To the extent the tax liability is not reimbursed by increasing the amount of the contribution, utility rates will have to be increased to pay for the tax, which would effectively force all utility customers to subsidize these projects.

The alternative is to approximately double the amount of the contributions to provide sufficient funds to pay the tax liability on the contribution and to complete the construction work.

Finally, A.G.A. stresses that Congressional approval of this proposal would avoid significant increases in Federal, state and local public construction project costs. Further, rate increases caused in part by this problem would be necessary and utility customers would not be forced to effectively subsidize these projects. Historically, these amounts were never included in the utility's rate base, and therefore, were never grounds for increasing customer rates.

EXPLORATION, DEVELOPMENT AND ENERGY FACILITIES

As further incentive to develop increased supplies of natural gas, A.G.A. also recommends that:

"Any surcharge revenue collected from customers under appropriate regulatory safeguards to be used exclusively for the exploration for, and development and transportation of, new sources of natural gas should be excluded from gross income of the gas company, and also,

"The costs of geological and geophysical work, feasibility and environmental studies, certification, start-up programs and other pre-operating expenses (including training costs) related to the establishment of new domestic energy facilities should be deductible as incurred, rather than capitalized and recovered over a period of years."

Under current law, the term "gross" income under Section 61 generally means all income from whatever source derived. The IRS takes the position that any surcharge revenue collected for the sole purpose of exploration and development is included in gross income. The IRS has also challenged the deductibility of the costs of geological and geophysical work, feasibility and environmental studies, certification, start-up programs and other pre-operating expenses related to the establishment of new domestic energy facilities. Instead of permitting a deduction for these expenses, the IRS is forcing companies to capitalize these expenses.

In an era of supply shortfalls and increased curtailments of natural gas, there is a need for a national emphasis on further exploration for and development of new supply sources. Drilling for natural gas is expensive and can run up to $350 a drilled foot. The costs of laying a mile of pipeline to reach the wellhead can run up to $700,000 a mile. The gas industry needs additional financial incentives to meet the high costs of further exploration and development. Many gas transmission and distribution companies are entering into exploration and development activities at great risk and expense to assure adequte supplies to meet their growing customer needs. Surcharges on gas customers' bills with appropriate regulatory safeguards would create additional capital for exploration and development of new natural gas supplies. But, inclusion of this surcharge revenue in the company's gross income diminishes its ability to form the necessary capital, and is counter-productive to long-range national energy goals.

If the federal income tax is applied to this revenue, the amount which is collected to pay the costs of exploration and development is, in effect, reduced by the percentage of the applicable corporate income tax rate, without any additional funding to make up this shortfall. Significant exploration and development by gas transmission and distribution companies is possible only if the necessary funds from such surcharges are excluded from the company's gross income. Any profits realized from such exploration and development ventures would be flowed back to the gas consumer.

New domestic energy facilities are also essential to meet our nation's critical natural gas supply requirements. Liquefied natural gas facilities and coal gasification plants can make valuable contributions to meeting supply shortfalls, but they are very capital-intensive projects. Gas companies are currently experiencing severe difficulties in raising capital in conventional money markets. Deductibility as current expenses of the costs associated with establishment of these new domestic energy facilities would enable the companies to generate the money internally for financing more of the actual construction of these projects. Forced capitalization of these expenses by IRS delays the generation of internal capital and inhibits the ability to finance further construction on essential production projects.

DEDUCTION OF TAXES, INTEREST AND OVERHEAD EXPENSES

A.G.A. also urges this Committee to consider amending Section 263(a)(1) of the Internal Revenue Code to expressly confirm by statute the long-standing practice of deducting taxes, interest, health and accident insurance, pension costs,

vacation pay, general overhead, and other overhead expenses. Deduction of these expenses should be permitted irrespective of accounting book treatment required by regulatory agencies, subject to the utilities' annual election available under existing law to capitalize these expenditures.

Under present law, any amount paid to acquire property or for a permanent improvement that extends beyond the tax year, generally is not deductible as a current expense. Instead, it is treated as a capital expenditure. However, there is frequently a difficult interpretative problem distinguishing expenditures that have the characteristics of both deductible expenses and capital expenditures.

Continued deductibility of these items is necessary to avoid impeding at this critical time recovery of capital and cashflow within the natural gas industry. If gas utilities are forced to capitalize these items, the recovery through depreciation of the capital involved is postponed for a period of years. This proposal would confirm long-standing practices within the industry of deducting currently the described expenditures while avoiding confrontations with the IRS concerning the interpretations of existing rulings and regulations.

The A.G.A. recommends this tax policy reform proposal to insure that the gas industry can generate internally the funds to finance exploration and development and supplemental gas supply projects. We also stress that continuing the internal generation of cash to meet financing needs by this proposal will not cause loss of stability in customer rates for gas service.

Mr. Chairman, this concludes my statement. I will be pleased to answer any questions the Committe may have. Thank you.

ATTACHMENTS

1. Natural Gas Remaining Recoverable U.S. Resources (Chart from "The Future for Gas Energy in the United States").
2. Future Total Potential Supplies of Gas (Chart from "The Future for Gas Energy in the United States").
3. Energy Analysis, 3/3/78, "A Forecast of Capital Requirements of the U.S. Gas Utility Industry to the Year 2000."
4. Energy Analysis, 9/6/77, "Evaluation of the President's Proposed Supply-Side Energy Strategy."
5. Energy Analysis, 5/18/78, "A Comparison of Capital Investment Requirements for Alternative Domestic Energy Supplies."
6. Energy Analysis, 12/16/77, "A Historical Comparison of Production and Consumer Costs of Natural Gas Versus Alternative Energy Forms."

A Forecast of Capital Requirements of the U.S. Gas Utility Industry to the Year 2000

A. INTRODUCTION

Historically, the capital needs of the gas utility industry have been for utility and pipeline construction, with small additional amounts for conventional gas exploration and development activities. Recently, however, because of increased projected gas needs and limitations on conventional production, gas utilities are beginning to invest in more capital intensive supplemental gas supply projects such as LNG, Alaskan gas and coal gasification. This relatively new trend, involving supplemental gas projects, constitutes a major new capital investment requirement for the U.S. gas utility industry.

This analysis estimates the capital investment which will be required by the U.S. gas utility industry for the development of supplemental gas supplies between now and the end of the century, and places this new requirement in the context of the projected traditional capital needs of the industry.

B. EXECUTIVE SUMMARY OF RESULTS

The capital needs of the U.S. gas utility industry for supplemental gas supply projects are estimated to total $97 billion (1977 dollars) between now and the end of the century, almost twice the current investment by the gas utility industry of $52 billion.

This estimate is based upon utility industry investment in supplemental gas supplies resulting in a total of 15 Tcf of production annually by the year 2000, a level which is achievable and, coupled with conventional lower 48 supplies, would maintain gas's present percentage contribution of almost 30 percent of total domestic energy consumption.

When the capital requirements for these supplemental gas supply projects are added to other utility capital requirements (e.g., pipeline and distribution system maintenance and construction and some exploration and development investments), the U.S. gas utility industry will have to increase its current investment of $52 billion by an estimated $204 billion (1977 dollars) of additional investment by the end of the century.

The annual capital investment of the U.S. gas utility industry is expected to rise from 1.9 percent of U.S. gross annual private investment in 1976 to 3.0 percent annually during the 1990's.

The ability of the U.S. gas utility industry to achieve this investment will require a legislative and regulatory environment which favors continued growth of the industry and a level of return on investment which is competitive with other opportunities in the capital markets.

C. GENERAL METHODOLOGY AND RESULTS

The methodology of this paper is: to project the realistically achievable contribution from each supplemental source of gas; to estimate the capital investment required to provide this level of each supplemental on the basis of current project costs (i.e., assuming no real construction cost increases beyond inflation); and to sum these figures.

On this basis, the cumulative U.S. gas utility industry capital requirement for supplemental gas projects is estimated to be $97.4 billion through the end of the century, an average investment increment of $4.4 billion annually (Exhibit 1).

To these totals are added projections of traditional gas utility industry investment for utility and pipeline construction and maintenance as well as for exploration and development, based upon a previously published survey of American Gas Association member companies.[1]

EXHIBIT 1.—CAPITAL REQUIREMENT ESTIMATES FOR THE U.S. GAS UTILITY INDUSTRY

[In billions of 1977 dollars]

	1978–80	1981–85	1986–90	Cumulative, 1978 1978–90	1991–2000	Cumulative, 1978–2000
Supplemental gas supplies:						
SNG[1]	0.9	1.7		2.6		2.6
Alaskan gas[2]	1.4	7.3	3.7	12.4	12.0	24.4
Mexican gas[3]		.2		.2		.2
LNG imports[4]	2.0	3.3	2.6	7.9	2.0	9.9
Coal gasification[5]		2.7	15.1	17.8	42.5	60.3
Subtotal	4.3	15.2	21.4	40.9	5€.5	97.4
Transmission, distribution, and other:[6]						
Utility and pipeline construction	9.0	16.4	17.5	42.9	35.0	77.9
Exploration and development	3.2	6.1	6.5	15.8	13.0	28.8
Subtotal	12.2	22.5	24.0	58.7	48.0	106.7
Total	16.5	37.7	45.4	99.6	104.5	204.1

[1] Assumes operation of SNG plants for baseload service.

[2] "Decision and Report to Congress on the Alaska Natural Gas Transportation System" (Washington, D.C., Executive Office of the President, September 1977), p. 110. Includes U.S. portion of investment only. The Canadian-financed portion of the investment would be $1,100,000,000. The years 1981–85 include investment of $400,000,000 in U.S.-flag LNG tankers for the southern Alaska gas.

[3] Tenneco, Inc., by communication with the American Gas Association, Feb. 17, 1978. The Mexican investment in this project will be $700,000,000 to $8C),000,000.

[4] The foreign investment required to serve the United States with 3 Tcf/yr of LNG by 2000 is projected to total appoximately $25,000,000,0C) consisting of $5,000,000,000 per ($1,700,000,000 per annual end-use quad) in foreign-flag LNG tankers (assuming 45 percent of U.S. LNG imports will move in foreign-flag tankers) and $20,000,000,000 ($6,400,000,000 per annual end-use quad) in foreign liquefaction, terminaling, and related onshore facilities.

[5] Based upon capital cost of $1,370,000,000 for a coal gasification plant of 250 MMscf/d capacity (2,470,000,000 per present annual end-use quad). Source: "A Comparison of Coal Use for Gasification versus Electrification" (Arlington Va., American Gas Association, Apr. 26, 1977). Figures escalated 5.5 percent to 1977 dollars. Excludes capital required just prior to 2000 for coal gasification plants to be completed just after that year (an added $12,300,000,000 between 1995 and 2000).

[6] Source: "Gas Utility Industry Capital Expenditure Projections, 1976–85" (Arlington, Va., American Gas Association, Oct. 1, 1976). Figures escalated to 1977 dollars. Estimates for 1978–85 are based upon a survey of gas utilities. Projections for 1986–2000 were obtained by extrapolating these estimates. Construction requirements derived by deducting SNG plant costs included therein (estimated as 10 percent of total) and extrapolating at a constant $3,400,000,000 annually. Exploration and development requirements extrapolated beyond 1985 at a flat $1,300,000,000 annually.

[1] Gas Utility Industry Capital Expenditure Projections 1976–1985 (Arlington, Va., American Gas Association, Oct. 1, 1976).

The cumulative total capital investment requirement of the U.S. gas utility industry is estimated to be $204.1 billion between 1978 and the end of the century, reaching a peak annual requirement of $10.5 billion in the 1990's.[2] By contrast, U.S. private gross domestic annual investment, if escalated forward at a real rate of 1.5 percent per year, would exceed $340 billion annually by the year 2000.

D. SUPPLEMENTAL GAS PROJECTS ASSUMPTIONS

Exhibit 2 presents the potential contribution to gas supply of supplemental supply projects. The estimates in the exhibit represent what the gas industry could reasonably achieve given favorable regulatory and legislative actions. Near-term estimates (i.e., through 1985) are based on approved projects and other projects for which substantial sponsor funds have been expended. Estimates for "New Technologies" assume continuation of current levels of industry and federal research, demonstration, and development.

Substitute natural gas (SNG) from liquids

If planned plants and currently operational plants operated twelve months a year, 0.6 Tcf could be produced by 1980.[3] The 1.2 Tcf shown for 1985 and beyond represents the total potential of plants already operating and in planning plus those projects already suspended or cancelled due to the adverse regulatory rulings concerning allocation of petroleum-based feedstocks.

Alaskan gas

South Alaska.—The South Alaska figure for 1985 is based upon the Cook Inlet project. Approval of the Pacific Lighting application is assumed, resulting in shipment of approximately 0.1 Tcf/yr to the lower 48 by 1985. By 1990, production from this project and others, both onshore and offshore, should be about 0.2 Tcf/yr. This could increase to 0.3 Tcf/yr by 1995 and to 0.6 Tcf/yr by 2000 as other regions south of the Arctic Circle are developed.

EXHIBIT 2.—POTENTIAL CONTRIBUTION FROM SUPPLEMENTAL SOURCES OF GAS

[In trillions of cubic feet]

Source	1976 actual	1980	1985	1990	1995	2000
SNG[1]	0.3	0.6	1.2	1.2	1.2	1.2
Alaskan gas:						
Southern[2]		.1	.1	.2	.3	.6
North Slope[3]			.7	1.4	2.2	3.0
Canadian gas	1.0	1.0	.9	.6	.6	.6
Mexican gas[4]		.4	.7	1.0	1.0	1.0
LNG imports[5]	[1].0	.6	1.6	2.4	3.0	3.0
Coal gasification[6]			.2	1.2	2.4	4.0
New technologies[7]			.1	.5	1.0	1.5
Total	1.3	2.7	5.5	8.5	11.7	14.9

[1] Includes plants in operation, approved, and planned, as well as plants suspended and canceled due to lack of feedstock allocations by DOE.
[2] Southern Alaska includes onshore and offshore production south of the Arctic Circle.
[3] Assumes a 2d major gas transportation system in operation by the early 1990's.
[4] Based on recent Pemex announcements and FPC (now FERC) filings.
[5] Includes announced projects only through 1985 and estimates thereafter.
[6] High-Btu gas only. Assumes loan guarantees for 1st few projects.
[7] Degasification of coal, gas from Devonian shale, tight formation, geopressured zones, biomass, in situ coal gasification, etc.

North Slope.—The FPC has recommended that the delivery system selected for gas from the North Slope have an initial delivery capability of 0.7–0.9 Tcf/yr. The figures in the table assume delivery of 0.7 Tcf by 1983 on the first system and, with looping, increase capacity to 1.4 Tcf by 1990. Construction of a second major delivery system beginning in 1990 is assumed which could add another 0.8 Tcf/year of delivery capacity by 1995. Finally, when this system is looped, adding another 0.7 Tcf/year, the total system would deliver 2.8–3.0 Tcf/year by 2000.

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[2] The capital requirement associated with gas from "New Technologies" is not included in these totals because of the lack of any firm basis for an estimate.
[3] "Status of SNG Projects", *Gas Supply Review*, vol. 5, No. 12 (Sept. 1977), p. 11.

Canadian gas

U.S. imports of Canadian gas have held steady at about the 1.0 Tcf/yr level for the past 6 years, largely from fields in British Columbia and Alberta. However, the Canadian Energy Board has announced that exports to the U.S. cannot be maintained at this level unless the frontier areas in Canada are developed. Since exploration and development activities in these areas and in the Arctic have been relatively successful to date, it is assumed that Canadian imports will continue at approximtaely current levels into the late 1980's. However, this level is expected to decline by 1990 due to increased Canadian domestic demand and depletion of British Columbia/Alberta resources.

Mexican gas

This estimate is based on recent announcements by the Mexican State Oil Company, Pemex, and recent filings to the Federal Energy Regulatory Commission. Discoveries of large oil deposits on the eastern shore of Mexico containing significant amounts of associated and dissolved gas have led to forecasts of natural gas production far in excess of Mexican needs. Assuming that pricing questions are resolved promptly, up to 400 Bcf/yr of Mexican gas could be delivered to U.S. markets by 1980. This level of imports could increase substantially as the Mexican oil fields are further developed and as gas processing facilities are built. Mexican imports are expected to reach 0.7 Tcf/yr by 1985 and could increase to 1.0 Tcf/yr by 1990 assuming new field discoveries offshore and in western Mexico.

LNG imports

While LNG imports are currently only at the 10–15 Bcf/yr level, several new projects nearing completion for importing LNG will increase the level of LNG imports to about 0.6 Tcf/yr by 1980. Additional projects presently pending before the Department of Energy would raise this level to 1.6 Tcf by 1985. The estimates for 1985 and beyond assume importation of some LNG from foreign sources other than Algeria and Indonesia, which may include Trinidad, Colombia, Nigeria, Australia, the Soviet Union, Iran and Arabian Gulf countries.

Coal gasification

High-Btu gas from coal is feasible using current, proven technology. A number of commercial plants are proposed and construction of the first few plants can proceed with federal loan guarantees. With such support, two plants producing a total of 0.2 Tcf could be operational by 1985. Subsequent capacity is projected at 13 plants by 1990, 24 plants by 1995, and about 44 plants by the year 2000. This growth rate is consistent with the rate of growth experienced by the nuclear power industry between the late 1950's and the early 1970's. Additionally, the gas industry and the U.S. Department of Energy are continuing their combined efforts to develop advanced coal gasification technologies which will enhance the commercial competitiveness of coal gasification in the 1990's.

New technologies

In-place resources of unconventional gas requiring new improved technology to permit economic recovery are substantial. These methane resources include 300–800 Tcf in coalbeds, 600 Tcf in tight formations, 3000 Tcf or more in geopressured zones and 500–600 Tcf in Devonian shale. For some of these sources, technology already permits production on a small commercial-scale. For most, economic incentives will be needed before full scale commercialization can be realized.

E. CAPITAL REQUIREMENTS ASSUMPTIONS

Capital costs have been estimated on the basis of announced project costs by adjusting those costs to 1977 dollars and assuming no real inflation in construction costs over general inflation in the economy (Exhibit 3).

Synthetic natural gas (SNG) from liquids

An average cost of $56.7 million for a 60 MMscf per day plant is determined by averaging the costs of both plants currently under construction.[4] The total investment required to achieve projected levels of SNG production assumes a favorable regulatory environment, allowing base-load operation of these plants. If SNG plants are required to operate only as seasonal peak shaving facilities, the required capital investment to achieve the projected quantities of gas will be substantially higher.

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[4] Op. Cit., Gas Supply Review.

EXHIBIT 3. U.S. CAPITAL COST PER UNIT

[In 1977 dollars]

Supplemental type	Unit	Cost
SNG [1]	60 MMscf/day plant	$56,700,000
Alaskan gas [2]	Northwest pipeline	7,000,000,000
	Proposed loop	5,000,000,000
Mexican [3]	28-mile 42 inch pipeline and 185 mile 36-inch pipeline	200,000,000
LNG imports [4]	365 Bcf/year terminal plus tankers	1,200,000,000
Coal gasification [5]	250 MMscf/day plant	1,370,000,000

[1] Assumes construction of SNG plants to be operated year round as base load. The cost for one such plant was determined by taking the average of the costs for two plants which are currently under construction.

[2] Decision and Report to Congress on the Alaska Natural Gas Transportation System, (Washington, D.C., Executive Office of the President, September 1977), p. 110. Includes U.S. portion of investment only.

[3] Tenneco, Inc., by communication with American Gas Association, February 17, 1978.

[4] Includes only U.S. investment for terminal, regasification and 55 percent of the LNG tankers. Foreign LNG investment for each 365 Bcf/year is approximately $650,000,000 for LNG tankers plus $2,300,000,000 for liquefaction, terminating, and other onshore facilities. While none of this foreign portion must be U.S. financed, it is anticipated that an average of 50 percent of the onshore cost will be U.S. financed. Initial Decision on Importation and Sale of Algerian Liquefied Gas, Tenneco Atlantic Pipeline Co., et al., docket Nos. CP77-100, et al., (Washington, D.C., Federal Energy Regulatory Administration, November 2, 1977), pp. 19, 22. Initial Decision Upon Applications to Import LNG from Algeria, El Paso Eastern Co., et al., docket Nos. CP77-330, et al., (Washington, D.C., Federal Energy Regulatory Administration, October 25, 1977), pp. 47, 53. Initial Decision on Importation of Liquefied Natural Gas From Indonesia, Pacific Indonesia LNG Co., Western LNG Terminal Associates, docket Nos. CP74-160, CP74-207, CP75-83-3 (Washington, D.C., Federal Power Commission, July 22, 1977), pp. 78, 80. Opinion and Order on Proposal to Import Liquefied Natural Gas to the United States from Algeria, opinion No. 796, Trunkline LNG Co., docket Nos. CP74-138, CP74-139, CP74-140 (Washington, D.C., Federal Power Commission, April 29, 1977), p. 3.

[5] A comparison of Coal Use for Gasification Versus Electrification, (Arlington, Virginia, American Gas Association, April 26, 1977).

LNG imports

The capital requirements for LNG imports reflects only the portion which must be borne by U.S. companies, i.e., the domestic receiving and regasification facilities and the 55% of LNG tankers which are expected to be of U.S. flag. The cost estimates are based upon currently pending projects (see footnote 4, Exhibit 3).

Mexican gas

The importation of Mexican gas will not require a substantial U.S. capital investment since large diameter pipe is already in place with surplus capacity to move these quantities of gas north. This fortuitous situation exists because of declining production in the South Texas region which the pipeline was originally built to serve. The cost estimate used here reflects the approximately 200 miles of connecting pipe that must be laid.

Alaskan gas

The estimates for Alaskan gas include the capital costs of the Alaska pipeline, looping of the pipeline, and U.S. flag LNG tankers (1978–1985 only) to deliver South Alaskan gas to the lower 48. The cumulative 1978–1990 capital cost of $12.4 billion reflects $7.0 billion for the Alaskan pipeline, $5.0 billion for the loop, and $.4 billion for LNG tankers, while the 1990–2000 capital cost reflects $7.0 billion for the Alaskan pipeline and $5.0 billion for a loop.

Estimates for the Alaskan pipeline and loops are taken directly from the President's final decision on the pipeline,[8] assuming that looping and mainline costs are equal on the Alaskan and Canadian portions. Only the U.S. portion of the financing is included here and the estimated cost is deflated to 1977 dollars using a 5.0% annual inflation assumption.

Coal gasification

Coal gasification cost estimates are taken from a 1976 C. F. Braun study prepared for the U.S. Energy Research and Development Administration,[9] inflated to 1977 dollars.

Canadian gas

Capital estimates are excluded for Canadian Gas and New Technologies for different reasons. The investment necessary to import Canadian Gas is already in place; only ordinary maintenance replacements on this transmission system are expected.

[8] "Decision and Report to Congress on the Alaska Natural Gas Transportation System," (Washington, D.C., Executive Office of the President, September 1977), p. 114.

[9] "Factored Estimates for Western Coal Commercial Concepts: Interim Report" (Washington, D.C., U.S. Energy Research and Development Administration, October 1976, p. 78.

New technologies

New technologies are in various research phases. Since no commercial projects are currently planned, capital costs estimates for the development of these technologies are not available.

Transmission, distribution, and other

Capital requirements for utility and pipeline construction, as well as for exploration and development, are likely to remain substantial over the forecast period. Approximately one-half of the utility and pipeline construction category of expenditures reflects capital costs associated with maintenance of the existing plant. The balance includes new transmission and distribution mains, as well as storage and small-scale LNG peak-shaving facilities.

The estimates shown in Exhibit 1 were derived from a previous A.G.A. survey of the gas utility industry[7] as follows: inflating all to 1977 dollars; deducting SNG plant costs which appear elsewhere in Exhibit 1 to avoid double-counting (estimated as 10% of the utility and pipeline category figures); and extrapolating beyond 1985 by assuming a constant capital requirement of $3.4 billion annually for utility and pipeline construction, and $1.3 billion annually for exploration and development. These are conservative estimates which assume no real increase in construction costs beyond inflation and do not include any allowances for gas industry participation in the Atlantic offshore development.

EVALUATION OF THE PRESIDENT'S PROPOSED SUPPLY-SIDE ENERGY STRATEGY

A. Introduction

The President's proposed National Energy Plan (NEP) forecasts on overall growth in energy use in the United States of more than 25 percent between 1976 and 1985. The additional consumption of 18.8 quadrillion Btu (quads) per year in 1985 is projected to be derived largely from coal (for direct industrial use and electric generation) and from nuclear power.

The purpose of this analysis is to evaluate the NEP's supply-side strategy in terms of its capital cost, consumer costs, resource utilization efficiency, and environmental loadings. Comparison with equivalent increases in natural gas based energy are drawn with the purpose of illustrating the benefit of including gas in the supply strategy in consonance with electricity and coal.

B. Executive Summary

The President's proposed supply-side energy strategy contains a projected additional annual consumption of 10.0 quads of energy for conversion to electricity, resulting in a delivery of 3.1 quads per year of electricity in 1985 to residential, commercial, and industrial energy users. In addition, the NEP projects the direct use of coal by industries to more than double, increasing by 6.2 quads per year by 1985. No increase in the nation's supply of natural gas, however, is foreseen to occur by 1985 in the NEP.

The capital and consumer costs of generating an added 3.1 quads per year of electricity are far greater than developing and using 4.8 quads per year of natural and supplemental gas. an equivalent energy delivery. Also, considerably more pollution and more rapid consumption of domestic resources because of conversion losses would result from producing 3.1 quads per year of electricity, instead of producing 4.8 quads per year of gas.

Four times as much capital will be required to construct electric generating facilities than the amount which would be needed to support the equivalent amount of gas production from a mixture of natural and supplemental sources ($148.2 billion versus $36.6 billion).

Consumers will be paying annually two and one-half times more for electricity than they would for an equivalent amount of useable energy from gas ($43.4 billion per year versus $16.6 billion).

Air pollutants and solid wastes associated with the coal and nuclear based electrification envisioned in the NEP exceed those associated with natural and supplemental gas development by three to thirty times, depending upon the pollutant being compared.

In addition, 1,040 million gallons per day of water will be required by the proposed addition of 3.1 quads of annual electricity generation, mostly for cooling purposes. This amount exceeds that required by the equivalent gas alternative by a factor of 17.

[7] Gas Utility Capital Expenditures 1976–1985 (Arlington, Va., American Gas Association, Oct. 1, 1976).

Production of 4.8 quads of natural gas is well within reach; approximately 6.6 quads per year of additional gas could be available by 1985 given appropriate federal policies toward gas pricing, offshore leasing, and encouragement of supplemental gas projects.

C. The President's Plan

The NEP projects a major alteration of final consumer energy supply and demand. The most significant aspect of the 1985 energy supply/demand balance, projected to occur as a result of the President's proposals, is the increase in coal electricity denand by the industrial and electric utility sectors and electric demand by the industrial and residential/commercial sectors. Indeed, significant growth in electricity demand (3 percent per year) is projected for the residential and commercial sector, while natural gas consumption grows less than 1 percent annually (see Table 1).

TABLE 1.—PROJECTED FUEL BALANCES BY SECTOR—ADMINISTRATION ESTIMATES

[Annual quads—10^{15} Btu per year]

	1976 estimated	1985	Projected change (1976-85) Quads	Percentage
Total energy demand	74.0	92.8	18.8	25
Residential and commercial:				
Oil	7.0	5.4	-1.6	-23
Natural gas	7.8	8.2	.4	5
Electricity [1]	12.6	16.8	4.2	33
Coal	.2	0	-.2	-100
Total	27.6	30.4	2.8	10
Industrial:				
Oil	6.4	8.0	1.6	25
Natural gas	8.8	9.0	.2	2
Electricity [1]	8.4	14.2	5.8	69
Coal	3.8	10.0	6.2	163
Total	27.4	41.2	13.8	50
Transportation:				
Oil	18.4	20.4	2.0	11
Natural gas	.6	.6	0	0
Total	19.0	21.0	2.0	11
Electricity [1]				
Oil	3.2	2.6	-.6	19
Natural gas	3.0	1.0	-2.0	-67
Coal	9.8	16.6	6.8	69
Nuclear	2.0	7.6	5.6	280
Other	3.0	3.2	.2	7
Total	21.0	31.0	10.0	48

[1] Numbers refer to energy required to produce electricity. Corresponding electricity distributed to users would be less than ⅓ of the amounts shown.

As a result of the growth in electricity demand by all sectors (48 percent increase over 1976 demand), total national consumption of energy for production of electricity will rise from 28 percent of all energy consumption in 1976 to 33 percent of all energy consumption in 1985, accounting for more than half of the total growth in energy consumption during that period. The NEP projects a net increase of 10 quads of energy to be used to generate electricity in 1985, resulting in a delivery of 3.1 quads. This represents an increase of 48 percent in electricity production. Slightly more than half this growth will come from coal (6.8 quads), the remainder from nuclear power (5.6 quads), while oil and gas consumption for electric generation declines (2.6 quads).

D. Natural Gas Availability

The U.S. Geological Survey,[1] the Potential Gas Committee,[2] and other reputable organizations have estimated recoverable conventional U.S. gas resources

[1] U.S. Geological Survey, Geological Estimates of Undiscovered Recoverable Oil and Gas Resources in the United States, Circular 725, 1975.
[2] Potential Gas Committee, Potential Supply of Natural Gas in the U.S., 1973.

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at 700 to 1,200 quads (35 to 60 years of supply at today's rate of 20 quads per year). Despite this substantial gas potential, the President's Plan does not provide sufficient economic incentives to encourage gas exploration and development. Indeed, most serious estimates suggest that, with deregulation of new gas wellhead prices, an additional 3 quads of natural gas could be produced annually by 1985.[8]

Beyond conventional resources, the natural gas industry is prepared through supplemental gas sources to deliver for U.S. consumption additional sizable quantities (5.6 quads) of pipeline quality gas (see Table 2).

TABLE 2.—1985 NATURAL GAS SUPPLY PROJECTIONS

[Annual quads—10^{15} Btu per year]

Supply	Natural gas industry capability	President's program	Additional gas beyond President's program
Lower 48[1]	20.0	17.0	3.0
SNG from petroleum feedstocks[2]	1.2	.5	.7
Coal gasification[3]	.4		.4
Alaskan gas[4]	1.2	.1	1.1
LNG imports[5]	2.0	.6	1.4
Canadian imports[6]	.6	.6	
Total	25.4	18.8	6.6

[1] Estimate assumes deregulation of the price of new natural gas in the current session of Congress.
[2] SNG production includes plants currently in operation, approved, and planned, as well as plants suspended and canceled due to lack of feedstocks.
[3] Coal gasification introduction by 1985 assumes loan guarantees for 1st few projects.
[4] Alaska production assumes 1 major gas transportation system in operation by 1985.
[5] LNG estimate based on announced projects.
[6] Canadian gas based on existing contracts.

TABLE 3.—DETAILED CALCULATION OF THE NATIONAL COSTS OF AN ADDITIONAL 3.1 QUADS OF ELECTRIC ENERGY

Category	Incremental energy[1] (quads)		Investment costs (billions), 1976			Annual consumer costs (billions), 1976		
	Electric	Natural gas	Electric[2]	Natural[3] gas	Difference	Electric[4]	Natural[5] gas	Difference
Residential and commercial	1.3	2.0	$62.1	$15.2	$46.9	$18.2	$7.0	$11.2
Industrial	1.8	2.8	86.1	21.4	64.7	25.2	9.6	15.6
Total	3.1	4.8	148.2	36.6	111.6	43.4	16.6	26.8

[1] Electric consumption of 3.1 quads replaced by 4.8 quads of natural gas presumes 100 percent end-use efficiency for electricity and 65 percent end-use efficiency of natural gas.
[2] Costs for additional electric capacity (about 50 percent each of nuclear and of coal with scrubbers) based on $1,100,000,000 per 1,000 Mwe nuclear and $900,000,000 per 1,000 Mwe coal where 1 quad electric requires 47.8 times 10^3 Mwe of electric capacity.
[3] 4.8 quads (1.4 Tcf LNG, 0.4 Tcf coal gas, 3.0 Tcf "new" gas from deregulation) requires investment of $5,200,000,000 for coal gas, $6,400,000,000 for LNG (U.S. investment) and $25,000,000,000 for "new" gas from deregulation (presumes FPC productivity of 300 Mcf/ft and costs per foot of $100 for high confidence, new horizon, deeper on and offshore drilling)
[4] Based on $14 per MMBtu for incremental electric costs from new coal and nuclear steam electric plants.
[5] Based on $4 per MMBtu for LNG, $5 per MMBtu for coal gas, and $3 per MMBtu for "new" natural gas from deregulation.

E. Capital and Consumer Costs

The President's Plan is expected to result in 3.1 quads of additional electric demand by 1985. This energy demand could be satisfied with other fuels, primarily with oil or natural gas. Of these two fuels, natural gas is the only one which could come almost entirely from domestic resources. Table 3 compares capital and final consumer costs of substituting natural gas for new electric generation. For this comparison, the incremental costs of 3.1 quads of electric energy (roughly 50 percent from coal and 50 percent from nuclear) are compared with the incremental costs of 4.8 quads of natural gas. (More natural gas energy is required since end-use efficiencies are somewhat higher for electric appliances and processes than natural gas end-use efficiencies.)

[8] American Gas Association, A Comparison of Estimates of Additional Natural Gas Production from Deregulation of New Gas Prices, Arlington, Va., May 1977.

Although natural gas reserves are estimated to be adequate for use through 1985, a comparison of conventional gas resource investment costs with those for coal and nuclear based electric generation suggests that electricity alone may not represent the most appropriate source for this increment of energy.

For this comparison, the 4.8 quads of natural gas is assumed to be provided by 1.4 quads of liquefied natural gas imports, 0.4 quads of coal gas (supplemental sources), and 3.0 quads of "new" gas from deregulation (conventional sources). The investment requirements for the natural gas supplies include only U.S. investment. Since electric generating facilities have an average expected life of roughly 25 years, investment requirements for gas supplies from supplemental gas facilities and from conventional gas wells reflect a 25-year production life. As can be seen, more than $111 billion (1976 dollars) of investment capital would be saved if natural gas were substituted for the 3.1 quads of electric energy forecasted in the President's Plan.

Using $14/MMBtu for the incremental cost of delivered electricity derived from coal and nuclear fuels, $4/MMBtu for LNG, $5/MMBtu for coal gas, and $3/MMBtu for "new" gas as average national consumer costs, it was determined that industrial/commercial consumers would save $11.2 billion if natural gas were consumed in place of electric energy. In other words, coal consumer electric costs are nearly two and one-half times greater than natural gas costs.

F. Environmental Loadings

Production of air emissions, water discharges, and solid wastes are projected to differ significantly under the two energy delivery scenarios evaluated (see Table 4).

TABLE 4.—ENVIRONMENTAL COMPARISON OF EQUIVALENT AMOUNTS OF GAS AND ELECTRICITY DELIVERED IN 1985

	Additional gas	Additional electricity
Basic assumptions (quads per year delivered to users)	3.0 natural gas	1.6 coal.
	1.4 lng	0 electric.
	.4 coal gas	1.5 nuclear.
Air emissions [1] (average pounds per hour):		
Particulates	12,800	39,600.
SO_2	18,300	79,500.
NO_x	166,700	544,600.
HC	[2] 190	9,500.
CO	20,500	31,700.
Solid wastes [3] (average tons per day)	6,800	130,000.
Water consumption [3] (million gallons per day, MGD)	60	1,040.

[1] Average pounds per hour estimates derived from Radian Corp., "A Western Regional Energy Development Study: Primary Environmental Impacts, Volume II," prepared for the Council on Environmental Quality and the FEA under contract No. EQ4AC037, August 1975. Capacity utilization factors assumed as follows: 95 percent natural gas and LNG; 90 percent coal gasification; 70 percent coal and nuclear based powerplants. End-use gas combustion estimates based on EPA, "Compilation of Air Pollutant Emission Factors" (AP-42), March 1975, and 4,000 hours per year combustion, approximately 50 percent.

[2] Methane (natural gas) flared and vented in gas production and collection processes is not included because CH_4 does not react in the atmosphere to help form smog; furthermore, no ambient air quality standard exists for methane.

[3] Derived from Radian Corp., supra.

Production of 3.1 quads per year of electricity will generate considerable quantities of air pollutants, virtually all of which are attributable to the coal electricity portion, even assuming SO_2 scrubbers and electrostatic precipitators for particulate removal. Coal mining emissions are included in the figures shown in Table 4, although these quantities are relatively minor. Nearly all the solid wastes generated by the electricity scenario are also attributable to the coal electric half. Finally, only about 25 percent of the rather substantial water consumption estimate for this scenario is attributable to the nuclear half. The remaining 793 million gallons per day—which is equivalent to the total water demand of a major U.S. city, such as the Washington, D.C. area—is attributable to the coal electric half by itself.

The equivalent gas supply scenario, on the other hand, causes generally about one-twentieth the environmental loading of the electrification scenario. For example, all three gas supply components—natural gas wells, LNG, and coal

gasification—together generate 18,300 pounds per hour of sulfur dioxide emissions with end-use burning included, but this amount is less than one-fourth the SO_2 emissions of NEP electrification (79,500 lbs/hr). All solid wastes (6,900 tons/day) produced by the gas scenario are attributable to high-Btu coal gasification; however, nineteen times that amount of solid wastes are produced by the equivalent electrification scenario.

Quantity of water consumption is the most striking difference between these two alternatives. An estimated 60 million gallons of water per day is consumed by the gas option (about half for gas production and half for coal gasification). More than seventeen times this amount of water is required by the electricity alternative (largely for cooling purposes).

G. Comparison of Resource Utilization Efficiencies

In comparison with other fuel sources, the energy efficiency of electrification is known to be low. For each unit of coal processed for electric power, for example, only 26.45 percent of its original Btu content is delivered to users on the average. Of the various processes that coal undergoes prior to delivery to users as electricity, the conversion process is the least efficient (32.4 percent of the original Btu content of the coal is left after electricity generation). Other stages—including extraction, processing, transport, and transmission—also result in minor losses of the Btu content of coal.[4]

Delivered natural gas, however, accounts for an average of 88.7 percent of the original resource and contains its full energy content. High-Btu coal gas contains approximately 57 percent of the coal's original energy content. Previous A.G.A. analysis showed that coal gas is more efficient than coal electric, including estimates of composite end-use efficiencies separately for appliances using conventional and advanced technologies. That study concluded that the coal-to-gas-through-user trajectory utilizes approximately 36 percent of original resource energy content to users, as opposed to 25 percent for the coal-electric-through-user system, assuming conventional end-use equipment.[5]

A Comparison of Capital Investment Requirements for Alternative Domestic Energy Supplies

A. Introduction

Development of any major new domestic energy supply—coal, oil shale, enhanced gas and oil recovery, Alaskan resources, solar energy, etc.—will require substantial capital investments. One of the most important decisions government and private energy planners face, therefore, is the selection of a capital efficient as well as cost-effective strategy for supplying energy from domestic resources.

The purpose of this analysis is to compare capital requirements for each new domestic energy supply source which could contribute in substantial quantity by the late 1980's to three end-use markets:

Residential and small commercial space heating.
Premium industrial fuels (e.g., process, feedstock, small boilers).
Large industrial boilers for steam and/or electricity generation.

The estimates of average capital requirements developed in this analysis include resource extraction, processing and conversion, transmission and distribution, and the cost of end-use equipment for each market. Average thermal efficiencies and energy losses in each step are also included as part of the analysis.

B. Executive Summary of Results of Analysis

In general, domestic energy supply and utilization systems based on gaseous fuels require substantially less (from 36 to 65 percent) new capital investment for all major end-use energy markets than equivalent nuclear, coal and solar electric systems or synthetic liquids-based systems (see Table 1).

[4] Intertechnology Corporation, Minerals Yearbook, 1969.
[5] American Gas Association, A Comparison of Coal Use for Gasification versus Electrification, Arlington, Va., April 1977.

TABLE 1.—AVERAGE CAPITAL INVESTMENT ESTIMATES FOR NEW DOMESTIC ENERGY

[1977 billion dollar per added annual quad]

Delivered fuel	Residential/commercial spaceheating		Premium industrial use	Large industrial boilers
	Conventional	Advanced		
Natural gas:				
Lower 48	$42.3	$62.9	$19.3	$8.9
Alaskan	56.2	71.2	32.0	25.9
Coal gasification:				
High-Btu gas	58.5	70.1	30.4	(1)
Medium-Btu gas	(1)	(1)	(1)	11.4
Coal liquids:				
Electric	89.7	97.8	88.6	(1)
Liquid	(1)	(1)	33.4	21.1
Coal electricity.				
Powerplant near end-users	89.0	97.9	85.1	(1)
Powerplant near coal mines	98.7	104.6	97.2	(1)
Combined cycle	74.2	87.1	69.1	(1)
Coal/direct-fired:				
SO_2 scrubbers	(1)	(1)	(1)	13.5
Fluidized-bed	(1)	(1)	(1)	12.0
Oil shale:				
Electricity	90.1	98.6	89.2	(1)
Distillate	57.4	(1)	28.2	22.0
Nuclear Electric	94.6	100.8	94.2	(1)
Solar:				
Thermal	(1)	269.1	(1)	(1)
Photovoltaic (current)	(1)	606.0	1,030.7	(1)
President's 1982 goal	(1)	241.3	361.6	(1)

[1] Not applicable or not included in this analysis.

Note: Terms "conventional" and "advanced" refer to end-use spaceheating equipment (e.g., furnaces versus heat pumps). Surface coal mining is the only mining cost assumed. Table 5 and appendix A show underground mining costs as well and other details.

On a national average basis, supplying added quantities of gaseous fuel from domestic resources for direct use in residential and commercial space heating will require 18-to-90 percent less capital than electrification for the same amount of useful energy.

The investment required to supply an additional annual quadrillion Btu's (Quad/yr) of new coal-fired or nuclear-based electricity for electric resistance space heating in residences and commercial establishments ranges from $74 billion to $99 billion, respectively.

Assuming deployment of electric heat pumps, the investment to provide an added quad/yr of electricity for residential and commercial space heating ranges from $87 to $105 billion.

By contrast, the investment for an additional annual quad of gaseous fuel for residential and commercial space heating equals from $42 billion for new natural gas supplies, and up to $59 billion for high-Btu gasification of surface-minded coal (assuming conventional gas heaters).

The investments for a quad of solar residential and commercial energy are $269 billion for solar thermal and $606 billion for solar photovoltaic.

Supplementing priority industrial requirements (e.g., process, feedstock, etc.) with domestic gaseous and liquid fuels is generally one-third as capital intensive (three times more capital efficient) as developing new supplies of electricity.

Synthetic gaseous and liquid fuel supplements require an average capital investment of $31 billion per annual quad for premium industrial end use, while the capital investment required to supply an added quad/yr of electricity for the same end use averages $87 billion.

The investment to supply an annual quad of medium-Btu coal gas for combustion in large (greater than 250 million Btu/hr) industrial steam and/or electric generation boilers is approximately $11 to $14 billion, depending upon whether the coal resources is surface- or underground-mined.

This capital requirement is comparable to that associated with direct coal combustion in large industrial boilers equipped with SO_2 scrubbers ($13 to $16 billion investment per annual Quad) or atmospheric fluidized bed ($12 to $14 billion investment per annual Quad.

C. Methodology

The capital investment estimates contained in this analysis include the following cost elements for each energy trajectory:

Resource extraction (e.g., drilling, mining, etc.)

Processing and/or conversion of resource from raw state to refined product suitable for shipment.

Transmission from point of processing/conversion to general locale of end-use.

Distribution to users.

Installation at the point of end-use of the equipment needed to utilize the energy (e.g., cost of space heaters, boilers, etc.).

The following procedure was followed for comparing each energy trajectory in this analysis.

1. Recent published capital cost data on each trajectory element (i.e., on extraction, processing, etc.) were assembled and evaluated. Cost estimates expressed in constant 1977 dollars were arrived at by selection or analysis (see Tables 2 and 3).

TABLE 2.—SOURCES OF CAPITAL COST ESTIMATES FOR ALTERNATIVE ENERGY TRAJECTORIES BASED ON DOMESTIC RESOURCES

Energy trajectory	Extraction	Processing/ conversion	Transmission	Distribution
Natural gas:				
Lower	58 cents per Mscf	$500 per bbl	$21.4 million per 275 MMscfd.	$8 million per 100 Mscfd.
Alaskan	70 cents per Mscf	do	$10 billion per 2.5 bscfd	Do.
Coal gasification:				
High Btu	$50 per ton (deep)	$1.3 billion per 250 MMscfd.	$21.4 million per 275 MMscfd.	$8 million per 100 MMscfd.
Medium Btu	$12 per ton (strip)	$170 million per 5 bbtu hr.	$5 per ton	$1.65 per MMBtu.
Coal liquids		$291 million per GW.		
Electric	$12 per ton	$1.5 billion per 63,500 bbld.[1]	$46 million per 180 Mbbld.	$11.1 million per 131 MW.
Liquid	do	do	do	$46 million per 180 Mbbld.
Coal electrification:				
Powerplant near end users.	do	$983 million per GW.	$5 per ton	$11.1 million per 131 MW.
Powerplant far from end users.	do	do	$167.9 million per 500 KV.	do Do.
Combined cycle	do	$637 million per GW.	$5 per ton	Do.
Coal—Direct use:				
Scrubbers	do	0	$5 per ton	$5 per ton.
Fluidized bed	do	0	do	Do.
Shale oil		$291 million per GW.		
Electric	$1.075 billion per 50 Mbbld.	$0.7 billion per 175 Mbbld.	$46 million per 180 Mbbld.	$11.1 million per 131 MW.
Liquid	do	do	do	$46 million per 180 Mbbld.
Nuclear-electric	$15 per ton	$879 million per GW.	0	$11.1 million per 131 MW.
		$38/SWU[2] $60 million per 500m. ton[2]. $62 million per 7,000m. ton.[2]		

[1] $1,900,000,000 for 60,000 BBld facility for premium industrial fuels only.

[2] The lower 3 figures related to nuclear processing capital costs: $ 38/SWU is the enrichment cost; $60,000,000 per 500m ton is the fabrication cost; $62,000,000 per 7,000m. ton is the conversion cost. The source is under reference 13 [in the appendix.

TABLE 3.—SOURCES OF END-USE CAPITAL COST DATA

Delivered fuel	Residential/commercial spaceheating	Premium industrial use	Large boiler use
Natural and supplemental gas (e.g., high-Btu coal gas).	$2,690 per 85.79 MMBtu.	$7 million per 60 MMBtu per hr.	$3.5 million per 25,000 lb hr.
Medium Btu coal gas	$4,667.32 per 3 ton (1)	(1)	$2.9 million per 250,000 lb hr.
Electricity	$2,775.74 per 53.08 MMBtu.	$14 million per 60 MMBtu per hr.	(1)
Coal (subbituminous)	$3,889.43 per 3 ton (1)	(1)	$15 million per 250,000 lb hr. $4.9 million per 100 MMBtu per hr.
Oil[2]	$3,410.17 per 81.91 MMBtu.	$7 million per 60 MMBtu per hr.	$3.5 million per 250,000 lb hr.
Solar:			
Thermal	$25.95 per sq ft	(1)	(1)
Electric	$2 per peak watt	$2 per peak watt	(1)

[1] Not available.
[2] No. 2 distillate oil for all end-uses except large boilers, for which No. 6 residual oil is assumed.

2. Similarly, recent published data on energy "losses" at each step (thermal efficiencies, physical losses, heat pump coefficients of performance, etc.) were analyzed and estimates were developed (see Table 4).

TABLE 4.—THERMAL EFFICIENCIES OF ENERGY TRAJECTORIES

[In percent]

	Extraction	Processing/ conversion	Transmission	Distribution	Residential/ commercial spaceheating	Premium industrial use	Large boiler use
Natural gas:							
Lower 48	99.55	96.7	95.0	97.0	85; 143	100	70
Alaskan							
Coal gasification:							
High Btu	99.2	59.0	95.0	97.0	85; 143	100	70
Medium Btu		78.0				(1)	85
Coal liquid:							
Electric	99.2	76.8	98.1	91.2	127; 184	100	(1)
Liquid				98.1	(1)	100	70
Coal electrification:							
Powerplant near end users	99.2		98.1	91.2	127; 184	100	(1)
Powerplant far from end users		32.4	91.2				
Combined cycle		38.1	98.1				
Coal—Direct use:							
Scrubbers	99.2	(1)	98.1	98.1	(1)	(1)	70
Fluidized bed combustion							
Shale oil:							
Electricity	37.0	87.8	98.1	91.2	127; 184	100	(1)
Liquid				98.1	87	100	70
Nuclear—electric	99.6	57; 31.0		91.1	127; 184	100	(1)
Solar:							
Thermal	(1)	(1)	(1)	(1)	56	(1)	(1)
Photovoltaic	(1)	20.0	(1)	(1)	127; 184	100	(1)

[1] Not applicable. Indicates that the fuel cycle does not include this stage or the delivered fuel is not used for the respective end use.

NOTES

GAS

Efficiency for conventional gas furnace, central air-conditioning is represented by the 1st figure in residential/commercial spaceheating.

The gas heat pump efficiency (the 2d figure under residential/commercial spaceheating) is a national average efficiency based on regional efficiency data for 6 regions that has been weighted according to each region's residential gas consumption in 1976 (AGA, 1977 Gas Facts).

ELECTRIC

Efficiency for conventional electric furnace, central air-conditioning is represented by the 1st figure in residential/commercial spaceheating.

The electric heat pump efficiency (the 2d figure under residential/commercial space-heating) is a national average efficiency based on regional efficiency data for 8 regions that has been weighted according to each region's 1975 residential electric consumption.

The electric generation unit for oil shale based and coal liquid (SRC) electricity is 38 percent.

Truck transport of oil is assumed to have 100 percent efficiency.

Processing efficiency in fuel cycle of nuclear electricity is represented by the 1st figure in processing/conversion.

Electric generation efficiency is the 2d figure for nuclear electricity processing conversion.

3. Using data in Table 4 along with other information, the capital cost estimates in Tables 2 and 3 were normalized on a basis of one added annual Quad realized by an end-use market. In other words, capital costs at each step were increased by an amount reflecting losses further along the way to and including the end-user, so that end-users receive the benefit of one Quad per year (see Appendix).

4. The estimated total capital requirement shown in Table 5 for each energy trajectory was arrived at by summing the normalized capital cost estimates developed in Item (3) above for each step (also shown in the last column of each table in the Appendix).

The following sections of this paper detail the individual capital requirements and efficiencies of each trajectory element.

D. Costs and Efficiencies of Resource Extraction

Capital requirement and efficiency estimates for extraction of domestic energy resources are as follows (shown in Tables 2 and 4 respectively):

Natural gas extraction. Natural gas extraction capital costs include dry hole costs as well as leasing and overhead costs (Reference 1). Alaskan gas extraction costs reflect the above consideration along with an added 20 percent to reflect higher costs of well construction.

Coal mining. Two separate coal extraction capital costs are shown, those for underground-mined and surface-mined coal. The cost of underground-mined coal shown in Table 2 assumes an Eastern U.S. mine and excludes leasing costs (2); surface-mined coal costs shown reflect an assumed Western location (3). Physical losses (efficiencies) are the same in both cases.

Shale oil mining. The extraction cost of oil shale shown in Table 2 includes costs of mining, crushing, retorting and disposal of spent shale (4).

Uranium mining. Uranium mining capital costs and efficiencies include underground mining as well as uranium milling (5).

Solar. No extraction costs required.

E. Costs and Efficiencies of Processing and Conversion

The following capital investments are required and efficiencies are expected, in connection with processing and/or conversion of each major domestic resource (separately or as a single step, as appropriate):

Natural gas processing. Gas processing generally involves a major field unit capable of odorization, removal of hydrogen sulfide, and other gas processing steps (6). No conversion costs are included in the future in Table 2 since processed natural gas is suitable for direct use in each of the end-uses compared in this analysis.

Coal Gasification. Capital costs shown for high-Btu coal gasification assume the Lurgi process with methanation, which has been proposed by the gas industry as part of a number of large-scale Western coal gas projects. The estimates shown in Table 2 include all gasification steps along with the average cost of linking the high-Btu coal gasification plant to existing gas pipeline systems (7). Efficiencies for high-Btu assume combustion of a part of the liquid products of the plant for on-site power generation. Medium-Btu coal gasification cost and efficiency figures are based on a Koppers-Totzek gasifier (8).

Coal-Fired Electricity Generation. The cost and efficiency of a coal-fired power plant reflect a 1000 MW unit with an overall capacity utilization factor of 70 percent, and include flue gas desulfurization (wet limestone scrubbers) designed to meet New Mexico state standards (9).

Combined Cycle-Electricity Generation. The costs and efficiencies for combined cycle are based on a 1825 MW Texaco based gasification-combined cycle unit (10) with a capacity utilization factor of 70 percent.

Synthetic liquids. Separate cost and efficiency data are shown for oil shale conversion reflecting (a) refining to distillate for direct use (11) and (b) refining to residual and electricity generation (11, 12). Coal liquids reflect SRC-II for boiler and electricity generation uses (36) and light hydrocarbons for premium industrial use (38).

Nuclear Power. Data in Tables 2 and 4 are unit capital costs and efficiencies associated with conversion, enrichment fuel fabrication, and electric generation. Nuclear power generation costs are based on a standard 1000 MW light water reactor (LWR) unit assuming a 70 percent capacity utilization factor. Major items in the capital cost of a nuclear power plant include the core generator and containment facilities (13, 14). Disposal and storage costs under current regulations are omitted because they are minor and no reliable data exist. New regulations currently under preparation may increase these costs substantially.

Solar. **No processing costs required.**

F. Costs and Efficiencies of Energy Transmission

Natural and Synthetic Gas. Gas transmission costs differ greatly for a lower 48 pipeline (15) and for the Alaskan pipeline (16). Both pipeline capital costs are averaged over the design throughput to correct for the shorter length of a "lower 48" gas pipeline than the proposed Northwest Alaskan Pipeline, and both estimates asume full pipeline utilization. It is assumed that high-Btu coal gasification plants will be constructed close to coal mine sites near long-distance gas pipelines; nevertheless, costs of new pipelines are included in this analysis. Capital costs of any short mine-to-gasification plant rail link and/or linkage to the existing pipeline network are included with capital costs for processing shown in Table 2.

Coal Handling. Long-distance hauling of coal is assumed to occur along refurbished railroad lines to electricity generation plants located near centers of end-use, as well as to medium-Btu coal gasification plants and combined cycle plants. Capital costs include equipment and road-bed upgrading based on projected 1980 throughputs (17). An analysis which assumed construction of new rail lines would result in significantly higher capital costs. Despite the large capital requirements associated with rail equipment and road-bed upgrading, the rail capital costs are understated on a Btu basis because refurbished rail lines are expected to carry significant amounts of coal in the future.

Electric Power Transmission. Power plants located near coal mines and far from end-users are assumed to be connected to consumer distribution networks via large, long-distance, extra-high voltage (EHV) power lines, with an average rating of 500 kv (18).

Synthetic Oil. Synthetic oil from shale or coal is assumed to flow to refineries which are located near points of end-use (i.e., either oil-fired electric generating stations or direct users of oil products). Costs and efficiencies of synthetic oil transmission shown in Tables 2 and 4, respectively, therefore, are based on transportation of crude oil by pipeline (19). The relatively low capital cost of oil transportation in terms of annual Btu's results from the high Btu content of oil.

Nuclear Energy Transportation. Nuclear power plants are assumed to be located near consumer distribution networks. No cost entry for nuclear transmission is shown in Table 2 because fabricated uranium fuel is ordinarily transported to electric generation plants in trucks four to five times a year, involving only minor costs.

Solar. No transmission costs required.

G. Costs and Efficiencies of Energy Distribution

Distribution costs refer to energy transportation systems which deliver fuel directly to consumers.

Gaseous Fuels. Gas distribution pipeline costs reflect average estimates for additions to existing domestic gas distribution systems (20). Medium-Btu coal gas cannot be comingled with natural gas and requires separate distribution systems. Thus, costs shown in Table 2 for medium-Btu coal gas distribution reflect new system capital requirements (20), including storage and main branch lines.

Liquid Fuels. The oil distribution cost and efficiency estimates shown in Tables 2 and 4 reflect both oil distributions pipelines and direct delivery to residential and commercial customers by truck (22, 23). Industrial customers (either premium or boiler uses) are assumed to receive their oil directly from nearby refineries via product distribution pipelines. Aside from scale, oil pipelines from refinery to industrial boiler users and to oil jobers for residential/commercial distribution are assumed to have technical and cost characteristics similar to oil pipelines to the refinery itself (24).

Electricity. Local EHV power distribution network costs and efficiencies shown in Tables 2 and 4 are identical for shale oil-fired, coal-fired, and nuclear-based electricity (25).

Solar. No distribution costs required.

H. Costs and Efficiencies of End-Use Devices

Capital outlays that are required by energy consumers are compared in this section (see Table 3).

Residential and Commercial Space Heating. Gas, oil, electric, and solar space heating devices compared in terms of costs and efficiencies in Tables 3 and 4 generally reflect existing technology. For purposes of comparison, electric and gas heat pumps are included in this analysis. Average national electric heat pump capital costs and efficiencies were calculated from regional coefficients weighted

according to estimated regional household market shares in 1975 (26). The cost of thermal solar heating, drawn from a recent analysis by General Electric Corporation (27), assumes a 1800-square-foot, well-insulated single family dwelling located in the mid Atlantic region. Future solar energy deployment costs may differ from the G.E. estimates generally as a result of changes in technology the photovoltaic capital costs are from recent estimates in Solar Energy Intelligence Report (28).

Premium Industrial Fuels. Premium industrial uses of fuel vary greatly with each industry. For the purpose of this analysis premium use of fuel by the glass industry was used because the glass industry can substitute premium fuels readily. The glass industry (SIC 3221) is one of the highest in terms of percent of total energy use served by gas (81%), and consumed about 0.2 trillion cubic feet of gas in 1976 (29). Costs and efficiencies shown in Tables 3 and 4 compared the costs of gas-fired, oil-fired and electric glass melting units (30). No site preparation costs are included in these figures.

Large Industrial Boilers. The average size of a large industrial boiler in the U.S. in 1973 was 212 MMBtu/hour (31). The closest available capital cost estimate (coal-fired) to the U.S. average is from the American Boiler Manufacturers Association (ABMA): $10 million for a 250 MMBtu/hour plus $5 million for flue gas scrubbers required by law on new units (32). Other information suggests that boiler costs will decrease on a unit basis as the size of the unit increases (33), thus actual direct-fired coal boiler costs may vary considerably upward or downward from the average. Oil and gas-fired boiler costs from ABMA also reflect 250 MMBtu/hour units, which are physically smaller than the comparable coal-fired unit and do not require flue gas scrubbers (although scrubbers may be required of new industrial oil-fired boilers by forthcoming revision to New Source Performance Standards) (34). Finally, fluidized bed combustion estimates reflect an atmospheric fluidized bed combustor (once-through sorbent process) equipped with an electrostatic precipitator (35). No site preparation estimates are included in any of the large boiler end-use costs.

I. Summary of Average Capital Requirements

The five preceding sections (Sections D through H) detail the major assumptions regarding costs and efficiencies of each energy trajectory element. This section brings together these elements and compares overall capital costs.

Following the steps outlined in Section C, the estimated average capital requirements for new domestic energy supplies based on information in Tables 2 3, and 4, are summarized as follows (see Table 5):

TABLE 5.—AVERAGE CAPITAL REQUIREMENT ESTIMATES FOR NEW DOMESTIC ENERGY[1]
[1977 billion dollars per added annual quad]

Delivered fuel	Residential/commercial spaceheating[2]		Premium industrial use[3]	Large industrial boilers[4]
	Conventional	Advanced		
Natural gas:				
Lower 48	$42.3	$62.9	$19.3	$8.9
Alaskan	56.2	71.2	32.0	25.9
Coal gasification:				
High-Btu gas	58.5	70.1	30.4	(5)
Medium-Btu gas	(5)	(5)	(5)	11.4
Coal liquids:				
Electric	89.7	97.8	88.6	(5)
Liquid	(5)	(5)	33.4	21.1
Coal electricity:				
Powerplant near end-users	89.0	97.9	85.1	(5)
Powerplant neal coal mines	96.7	104.5	97.2	(5)
Combined cycle	74.2	87.1	69.0	(5)
Coal/direct fired:				
SO_2 scrubbers	(5)	(5)	(5)	13.5
Fluidized bed	(5)	(5)	(5)	12.0
Oil shale:				
Electricity	90.1	98.6	89.2	(5)
Distillate	57.4	(5)	28.2	22.6
Nuclear electric	94.6	100.8	94.2	(5)
Solar:				
Thermal	(5)	269.1	(5)	(5)
Photovoltaic (current)	(5)	606.0	1,030.7	(5)
President's 1982 goal	(5)	241.3	361.6	(5)

See footnotes on p. 419.

Conventional R/C Spaceheating.—Capital requirements to supply new domestic energy to the residential and commercial spaceheating market are estimated to vary from $42 billion to $606 billion per annual end-use quad (estimates for new natural gas with conventional furnaces and photovoltaic solar energy, respectively). The following are estimated to lie between these two extremes:

Electricity capital requirements range from $74.0 billion to $98.7 billion per added end-use Quad (conventional resistance heaters) respectively based on surface-mined combined cycle power plants located near end-users and on coal-fired, respectively. Underground coal mining would add $4.4 billion to the coal-fired power estimate. Location of the coal-fired power plants far from end-users (i.e., near remote surface-mines) would add $9.7 billion to the capital requirement estimate chiefly because long-distance EHV-transmission is less cost-efficient than rail-haul using refurbished equipment and trackwork. Finally, if both underground mines and remote power plant locations are assumed, an added $14.4 billion investment would be needed to supply one Quad/year of coal-based electricity. The resulting capital requirement ($103.4 billion per annual Quad) would exceed the nuclear power requirement of $94.0 billion.

Gas capital costs range from $42.3 billion to $58.5 billion reflecting new natural gas and high-Btu coal gasification, respectively (conventional gas furnaces). Costs associated with constructing underground coal mines would increase the high-Btu coal gas estimate to $62.0 billion per annual end-use Quad. Coal gasification plants are assumed to be located near Western mines, far from end-users, with the product gas commingled with natural gas in long-distance gas pipelines.

Oil from shale or coal can be utilized in the R/C spaceheating market as electricity ($90 billion per annual end-use Quad) or as distillate fuel oil ($57 billion).

Nuclear electricity, as indicated above and in Table 5, requires an estimated capital investment of $94.0 billion per annual end-use Quad for R/C spaceheating.

Advanced R/C Spaceheating.—Deployment of heat pump technology substantially changes the estimated capital investment requirement on a per annual end-use Quad basis. Installed capacity requirements for any trajectory are the same for conventional and advanced, however, in order to account for peaking capacity required during heat pump defrost cycles. For Table 5, the following procedure was used to account for peak load capacity requirements, above and beyond required base load associated with heat pump deployment. First the amount of peaking capacity required is set to equal the difference between conventional and advanced technology requirements. The peaking capacity requirement was then divided by the cost of the base load power plants to determine the amount of base load energy that should be costed as peak energy. This amount was then multiplied by the cost of peak energy units. In the case of electricity, it was assumed that oil based electric generation units would be for peak use and in the case of gas, SNG plants were assumed to be the peak energy source. Finally, the product of the peak energy generation units (oil based electric generation or SNG) costs and peak energy requirements was added to the extra distribution cost to arrive at the total peak energy capital requirement.

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[1] Based on surface-mined coal, estimated costs of 1977 strip mining law (Public Law 95-87) included. Estimated cost[5] based on underground mining are as follows:

	R/C		Industrial	
	Conventional	Advanced	Premium	Large boilers
High-Btu coal gas	61.9	71.4	33.2	(1)
Medium-Btu coal gas	(1)	(1)	(1)	(1)
Coal electricity near users	93.4	100.4	90.4	(1)
Coal electricity near mines	103.4	107.9	103.2	(1)
Combined cycle	79.1	89.9	83.0	(1)
Direct-fired W/FGD	(1)	(1)	(1)	15.8
Direct-fired W/AFB	(1)	(1)	(1)	14.5

[1] Not applicable or not included in this analysis.

[2] From appendix, table A-1, with added peaking required for heat pumps.
[3] From appendix, table A-2.
[4] From appendix, table A-3.
[5] Not applicable or not included in this analysis.

Electricity capital requirements assuming heat pumps range from $87.1 billion to $107.9 billion per annual end-use Quad on a sales-weighted national average heat-pumps performance (COP) basis.

Gas-fired heat pumps would similarly change capital investment requirements for deploying new gas supply and use capacity in the R/C spaceheating sector. The capital costs of adding one annual Quad of natural gas and of coal gasification for this market would equal $62.9 billion and $70.1 billion, respectively.

Solar energy deployment capital requirements are estimated at $269.1 billion per annual end-use Quad for thermal energy and range from $241.3 to $606.0 billion per end-use Quad for photovoltaic energy.

Premium Industrial Fuels. As shown in the third column of Table 5, such supplemental gas supplies as Alaskan and high-Btu coal gas, ($32.0 billion and $30.4 billion, respectively) would require on the order of one-third the investment of the same amount of electricity to meet the needs of the market. Electrification for use as a replacement for premium industrial fuels would require from $69.0 to $97.2 billion per annual end-use Quad.

Large Industrial Boilers. The capital investment required to add one annual Quad of large boiler fuel supply and capacity based on the use of coal, on a national average is likely to range from $12.0 billion to $13.5 billion, depending primarily upon mining and end-use technology (Table 5, last column). At $11.4 to $14.5 billion per annual end-use Quad (surface versus underground coal mines), the capital requirement of medium-Btu coal gas for large boilers falls between that of direct-combustion with wet limestone SO_2 scrubbers ($13.5 to 15.8 billion per annual end-use Quad) and atmospheric fluidized bed-boilers ($13.0 to 14.5 billion).

Appendix A

The total capital investment requirements shown in Tables 1 and 5 result from summing the fuel cycle capital cost estimates shown in Table A-1 (residential-Commercial Space Heating), Table A-2 (Premium Industrial Fuel Use), and Table A-3 (Large Boiler Fuel Use). Each element in each energy trajectory has its capital investment requirement expressed in terms of 1977 billion dollars per added annual Quad through and including the point of end use.

TABLE A-1.—CAPITAL COST ESTIMATES FOR RESIDENTIAL AND SMALL COMMERCIAL SPACE HEATING

[1977 $ billions per annual quad utilized by end users]

Category	Extraction	Processing/conversion	Transmission	Distribution	End use	Total[4]
Natural gas:						
Lower 48	4.50 (2.68)	.25 (0.15)	.36 (0.21)	.26 (0.14)	36.88 (57.47)	42.25 (60.65)
Alaskan	5.40 (3.22)	.25 (0.15)	13.45 (7.99)	.26 (0.14)	36.88 (57.47)	56.24 (68.97)
Coal electricity:						
A. Powerplant near end users:						
1. Deep mined	6.18 (4.29)	40.55 (28.16)	.54 (1.36)	4.96 (3.43)	41.17 (58.98)	93.40 (95.22)
2. Strip mined	1.81 (1.26)	40.55 (28.16)	.54 (0.36)	4.96 (3.43)	41.17 (58.98)	89.03 (92.19)
B. Powerplant far from end users:						
1. Deep mined	6.65 (4.64)	44.4 (30.74)	6.21 (4.31)	4.96 (3.43)	41.17 (58.98)	103.39 (102.10)
2. Strip mined	1.95 (1.36)	44.4 (30.74)	6.21 (4.31)	4.96 (3.43)	41.17 (58.98)	98.70 (98.82)
C. Combined cycle:						
1. Deep mined	5.65 (3.92)	26.2 (18.20)	.44 (0.31)	4.96 (3.43)	41.17 (58.98)	79.12 (84.84)
2. Strip mined	1.66 (1.15)	26.2 (18.20)	.44 (0.30)	4.96 (3.43)	41.17 (58.98)	74.43 (82.07)
Coal gas—High Btu:						
1. Deep mined	4.76 (2.21)	19.60 (9.38)	.36 (0.21)	.26 (0.14)	36.88 (57.47)	61.86 (69.41)
2. Strip mined	1.40 (0.65)	19.60 (9.38)	.36 (0.21)	.26 (0.14)	36.88 (57.47)	58.50 (67.85)
Coal liquids: Electric	2.01 (1.39)	[1] 27.25 13.99 (18.88) (9.71)	.27 (0.19)	4.96 (3.43)	41.17 (58.98)	89.65 (92.58)
Oil shale		[2] 4.91 13.99				
Electric	24.80 (17.1)	(3.31) (9.71)	.27 (0.19)	4.96 (3.43)	41.17 (58.98)	90.10 (97.72)
Direct use	12.79	2.49	.16	.14	41.63	57.21
Nuclear electric	14.6×10^{-4} (9.9×10^{-4})	[3] 11.70; 36.20 (8.07; 25.15)		4.96 (3.43)	41.17 (58.98)	94.63 (95.63)

See footnotes at end of table.

TABLE A-1.—CAPITAL COST ESTIMATE FOR RESIDENTIAL AND SMALL COMMERCIAL SPACE HEATING—Con.

Category	Extraction	Processing/conversion	Transmission	Distribution	End use	Total [4]
Solar:						
Thermal					(269.1)	(269.1)
Photovoltaic electric (current)		790.3 (546.98)			41.17 (58.98)	831.5 (605.96)
President's 1982 goal		263.44 (182.33)			41.17 (58.98)	304.61 (241.31)

[1] The 1st figure is the solvent refined coal process capital cost. The second figure is the oil-fired electric generation capital cost.
[2] The 1st figure is the oil refinery capital cost. The second figure is the oil-fired electric generation capital cost.
[3] The 1st figure is the summation of conversion, enrichment, and fabrication capital costs. The 2d figure is the nuclear generation capital cost.
[4] Totals are also shown in tables 1 and 5 except that advanced end use technology totals (in parentheses) are greater than the sum of the fuel cycle components shown here to reflect extra peakload generating capacity assumed for electric and gas heat pumps to accommodate both the compressor and the strip heater demands simultaneously during defrost cycles.

Note: Capital costs in parentheses are estimated on the basis of advanced technology space heating efficiencies.

TABLE A-2.—CAPITAL COST ESTIMATES FOR PREMIUM INDUSTRIAL FUEL USE

[1977 dollars per annual MMBtu utilized by end users]

Category	Extraction	Processing/conversion	Transmission	Distribution	End use	Total [1]
Natural gas:						
Lower 48	4.06	0.23	0.23	0.22	14.6	19.34
Alaskan	4.87	.23	12.06	.22	14.6	31.98
High-Btu coal gas:						
1. Deep mined	4.05	14.13	.23	.22	14.6	33.23
2. Strip mined	1.19	14.13	.23	.22	14.6	30.37
Coal liquids:						
Electric	2.54	[2] 34.6; 17.78	.39	6.30	27.0	88.61
Distillate	.90	17.63	.12	.12	14.6	33.37
Oil shale:						
Electric	31.50	[3] 6.23; 17.78	.39	6.30	27.0	89.20
Distillate	11.12	2.20	.12	.12	14.6	28.16
Coal electric:						
(a) Powerplant near end users:						
1. Deep mined	7.50	48.90	.68	6.30	27.0	90.38
2. Strip mined	2.20	48.90	.68	6.30	27.0	85.08
(b) Powerplant far from end users:						
1. Deep mined	8.36	53.60	7.89	6.30	27.0	103.15
2. Strip mined	2.45	53.60	7.89	6.30	27.0	97.24
(c) Combined cycle:						
1. Deep mined	7.16	33.37	.27	6.30	27.0	74.10
2. Strip mined	2.08	33.37	.27	6.30	27.0	69.00
Nuclear electric	[4] 18x6x10	[1] 14.84; 46.05		6.30	27.0	94.19
Solar:						
Photovoltaic (current)		1,003.71			27.0	1,030.70
President's 1982 proposal		234.57			27.0	361.57

[1] The 1st figure is the summation of conversion, enrichment, and fabrication capital costs. The 2d figure is the nuclear electric generation capital cost.
[2] The 1st figure is the solvent refined coal process capital cost. The 2d figure is the oil-fired electric generation capital cost.
[3] The 1st figure applies to the refinery. The 2d figure applies to an oil-fired electric generator.
[4] Also shown in tables 1 and 5.

TABLE A-3.—CAPITAL COST ESTIMATES FOR LARGE BOILER FUEL USE

[1977 dollars per annual MMBtu utilized by end users]

Category	Extraction	Processing/ conversion	Trans- mission	Distri- bution	End use	Total[1]
Natural gas:						
Lower 48	5.45	0.31	0.31	0.31	2.50	8.88
Alaskan	6.54	.31	16.20	.31	.50	23.86
Coal:						
Direct fired (scrubbers):						
1. Deep mined	3.28	0	0.29		12.24	15.81
2. Strip mined	.96	0	.29		12.24	13.49
Medium-Btu gas:						
1. Deep mined	4.26	6.16	.36	1.94	1.73	14.45
2. Strip mined	1.25	6.16	.36	1.94	1.73	11.44
Fluidized bed combustion:						
1. Deep mined	3.30	0	.28		10.80	14.38
2. Strip mined	.96	0	.28		10.80	12.04
Coal liquids (strip mined)	1.26	17.20	.17		2.50	21.13
Oil shale	15.90	3.15	.17	.17	2.50	21.89

[1]Also shown in tables 1 and 5.

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A Historical Comparison of Production and Consumer Costs of Natural Gas vs. Alternative Energy Forms

A. Introduction

Much attention is currently being given to the increases during the past several years in the wellhead price of new natural gas. This subject has been of particular interest in the debate on new gas price deregulation. This paper reviews the history of natural gas price increases both at the wellhead and delivered to consumers. It also compares these price trends with the price trends for competitive fuels.

B. Executive Summary

Wellhead prices of natural gas have risen at an annual compounded rate of about 9.3 percent since 1960.

Drilling costs have risen at rates very similar to those of wellhead prices during this period.

End user (i.e. delivered) prices for residential and commercial natural gas customers have risen at less than half the rate of increase of wellhead prices and gas prices to industrial end users.

While wellhead prices of natural gas have increased at an average annual rate of about 9.3 percent since 1960, residential natural gas prices have risen at only 4.4 percent year year in the same period.

Commercial gas prices have risen at rates much like the residential prices but slightly higher. For example, the annual growth since 1960 has been 4.8 percent.

Industrial gas prices have increased at rates more than twice that experienced by the residential customer, i.e. 9.1 percent per year since 1960—very similar to the increase in average wellhead price.

All residential fuels (oil, gas and electricity) have increased at annual rates between 2 to 7 percent over the past sixteen years. Since 1950 natural gas has been the least expensive fuel, and even now, the price is only 66 percent of the price of oil and 20 percent of the price of electricity. Electricity prices while the highest of all fuels, have experienced the lowest rate of increase; number 2 fuel oil has increased at the highest rate. Natural gas prices since 1960 have increased at rates about equal to the consumer price index (CPI).

Since 1970 the price of number 2 fuel oil has increased about 15 percent per year and natural gas about 11 percent per year.

Natural gas prices at the wellhead have increased much the same as other fuels, but more than most minerals. For example, they have increased at about the same rate as crude oil and zinc prices and at a somewhat lower rate than bituminous coal prices over the period of the last 5 to 15 years.

C. Natural Gas Prices

Table 1 lists the prices of natural gas at the wellhead, drilling costs and residential, commercial and industrial prices for selected years from 1950 to 1976. Annual average growth rates are also tabulated to permit comparisons among the various prices.

Annual growth rates for the 1970–1976 period are considerably higher than for the 1950–1976 or the 1960–1976 periods. The most rapid growth period for gas prices has been the past six years. The higher recent growth rates also cause the 1960–1976 rates to be higher than the 1950–1976 rates.

It is important to note that the lowest growth in prices has occurred in the residential prices. Commercial prices have increased only slightly more. In sharp contrast, the wellhead prices have risen at more than twice the rate of residential prices. Similarly, industrial gas prices have risen at more than twice the rate of residential gas prices.

This comparison of growth rates shows that the industrial customer has paid increasingly large bills corresponding to the rate of increase of the average wellhead gas price. Residential and commercial prices have increased much more slowly.

D. Residential Fuel Prices

Residential fuel prices are compared in Table 2. Number 2 fuel oil, electricity and natural gas residential prices in dollars per million Btu for selected years are shown from 1950 to 1976. Also shown is the Consumer Price Index (CPI) for the same years (CPI for 1967 is 100). Similar to the trend seen in Table 1 the more recent growth rates are the highest.

In terms of absolute cost natural gas has consistently been less expensive than either of the other fuels. Natural gas prices have increased less than those for fuel oil but more than those for electricity. The lower growth rate of electricity has narrowed the gap between gas and electricity prices. In 1950 electricity was almost ten times more expensive than natural gas; in 1976 electricity was five times more expensive than natural gas. Number 2 fuel oil has been much more price competitive with natural gas. In 1950 oil was slightly more than 3 percent more expensive and in 1976 oil was 52 percent more expensive.

E. Other Commodities

Crude oil, coal, natural gas, aluminum, zinc and tin prices are compared for 1960, 1970 and 1975 in Table 3. Generally, zinc and tin are minerals for which the prices have increased significantly in the past fifteen years. Aluminum prices have been more typical of other mineral prices. Prices of the three minerals and the three primary hydrocarbon fuels show that fuel prices have escalated more rapidly than have the mineral prices in the past fifteen years.

Natural gas prices at the wellhead have increased at a slightly higher rate than crude oil prices but not as much as bituminous coal. Among the minerals only zinc prices have grown at about the same rate as natural gas prices since 1960.

F. Conclusions

Natural gas prices have increased significantly in the past sixteen years although in the same range as other fuels. Most of these gas price increases have been absorbed by the industrial market. In contrast the residential market prices increased at less than half the rate at which wellhead prices increased.

Residential fuel customers have seen all fuel prices increasing in the past six years. Number 2 fuel oil rose at the highest rate, but electricity was by far the most expensive. Electric prices have risen at a very low rate but even this low rate of increase has not yet changed the large difference (a factor of five) between the high cost of electric energy versus energy in the form of natural gas.

Among minerals only zinc has increased in price as much as fuels. Among the hydrocarbons such as crude oil, bituminous coal and natural gas the average annual growth rates are comparable. Bituminous coal has experienced greater price increases than either natural gas or crude oil.

TABLE 1.—NATURAL GAS PRICES

[Prices in dollars per million Btu]

	1950	1960	1970	1976	Annual growth rate (percent) 1950–76	1960–76	1970–76
Wellhead:							
Average [1]	$0.065	$0.140	$0.171	$0.58	8.8	9.3	22.6
New [2]	.158	1.78	.248	1.38	8.7	13.7	33.1
Drilling costs [3] (dollars per well)	NA	[4] $134,355	$173,104	[5] $334,176	NA	[6] 9.5	[7] 14.1
End user [6]:							
Residential	$0.85	$1.00	$1.06	$1.98	3.3	4.4	11.0
Commercial	.65	.79	.81	1.68	3.7	4.8	12.9
Industrial	.21	.33	.38	1.32	7.3	9.1	23.0

[1] U.S. Bureau of Mines, Natural Gas Annual.
[2] Texas RRC district 3 contract price for new interstate sales, Sales by Producers of Natural Gas to Interstate Pipeline Companies, Federal Power Commission.
[3] Average gas well drilling cost for a 7,500- to 9,999-foot well in Texas as reported in Joint Association Survey Vol. 1.
[4] Information is not available prior to 1965.
[5] Information is not available after 1975.
[6] Annual growth rate, 1965–75.
[7] Annual growth rate, 1970–75.

TABLE 2.—RESIDENTIAL FUEL PRICES

	1950	1960	1970	1976	Annual growth rate (percent) 1950–76	1960–76	1970–76
Oil No. 2 [1] (dollars per million Btu)	$0.88	$1.08	$1.33	$3.01	4.9	6.6	14.6
Electricity [2] (dollars per million Btu)	8.44	7.24	6.15	10.11	<1	2.1	8.6
Natural gas [3] (dollars per million Btu)	.85	1.00	1.06	1.98	3.3	4.4	11
Consumer price index [4]	72.1	88.6	116.3	170.5	3.4	4.2	6.6

[1] Bureaus of Labor Statistics, retail Prices and Indexes of Fuels and Utilities.
[2] Edison Electric Institute Statistical Yearbook.
[3] A.G.A. Gas Facts.
[4] Bureau of Labor Statistics, Consumer Price Index.

TABLE 3.—OTHER FUEL AND MINERAL PRICE CHANGES

	1960	1970	1975	Annual growth rate (percent) 1960–75	1970–75
Tin (cents per pound)	101.44	174.21	339.82	8.4	14.3
Zinc (cents per pound)	12.946	15.319	38.959	7.6	20.5
Aluminum (cents per pound)	26.00	28.72	39.40	2.8	6.5
Bituminous coal (dollars per ton)	4.69	6.26	18.75	9.7	24.5
Crude oil (dollars per barrel)	2.88	3.18	8.00	7.0	20.3
Natural gas (dollars per 1,000 ft³) (average wellhead)	.140	.171	.445	8.0	21.1

Source: Statistical Abstract of the United States, tables 1195, 1211, 1207, U.S. Department of Commerce, 1976.

The CHAIRMAN. We will meet again at 10:00 tomorrow. Starting on Wednesday, we are going to start at 9:00 o'clock.

(Thereupon, at 1:45 p.m., the Committee recessed, to reconvene at 10:00 a.m. on Tuesday, August 22, 1978.)

33-017—78——15

THE REVENUE ACT OF 1978

TUESDAY, AUGUST 22, 1978

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

The committee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Nelson, Bentsen, Moynihan, Curtis, Hansen, Packwood, Roth, Jr., Danforth, and Laxalt.

The CHAIRMAN. I am going to call this meeting to order. Other Senators will be along as the hearing proceeds.

We are pleased to have as our first witness today Mr. Andrew J. Biemiller, director of the Department of Legislation, AFL-CIO.

Mr. Biemiller, we are very pleased to welcome you back before our committee.

STATEMENT OF ANDREW J. BIEMILLER, DIRECTOR, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. BIEMILLER. Thank you, Mr. Chairman.

I am accompanied by our legislative representative, Mr. Ray Denison and by the assistant director of our research department, Mr. Arnold Cantor.

Mr. Chairman, we are here to oppose the House-passed "Revenue Act of 1978" and urge enactment of a simple, straight-forward tax cut that honestly provides relief to those who need it.

The House measure does not meet that test and should be rejected.

Instead, we recommend that the present $35 general tax credit be increased to $150 and a 5-percent income tax credit granted for payments made for social security. Under our proposal, taxes would be reduced by some $21 billion in 1979; most working families would receive a cut of $450 or more; and most relief would go to those groups hardest hit by inflated prices of basic necessities and increases in social security payroll taxes.

The grossly inequitable House bill benefits primarily higher income taxpayers and individuals with large amounts of sheltered income and corporations. Of the $16.3 billion tax cut, the great majority of taxpayers—88 percent with annual incomes of $30,000 or less—would receive only one-third of the relief. But $10 billion would go to business and those at the top of the income ladder.

As a result of the House bill:

Some 2.6 million taxpayers—2 million in the $15,000 and below income group—would pay more in taxes.

Over 25 percent of the total amount in individual income tax cuts would go to those with annual incomes of $50,000 or more—only 3 percent of the taxpayers. Another $1 billion would go to this same group as a result of the capital gains cuts.

Those earning $50,000 and above would get an average of $1,400 in tax rate cuts. Those in the $30,000 and below group, 88 percent, would benefit by less than $100.

The House bill has been labeled as "tax relief for middle-income Americans." Let's look at what "middle income" really is.

Half of the Nation's families have annual earnings of less than $16,000. Only 5 percent have incomes above $40,000.

Excluding the lowest 20 percent—the poor—and the highest 20 percent, the broadest definition of middle-income American families is the 60 percent with incomes between $8,000 and $26,000.

For this group, the House "tax relief" averages less than $100. That is tax relief?

The House bill would obviously flunk the "truth-in-labeling" law.

In contrast, our proposal really helps the middle-income taxpayer. A family of four earning $10,000 a year would receive a cut of $477 compared to $62 under the House bill. At $15,000 our cut totals $475; the House bill $77. At $20,000, our cut would be $481; the House bill $146. At $25,000, our tax cut would be $490; the House cut $232.

Capital gains are a major loophole for the wealthy and all the House bill does—with one exception—is make it worse. The once-in-a-lifetime $100,000 exemption on the sale of a principal residence would benefit more than a half-million taxpayers and more than 80 percent of the relief going to those with incomes under $50,000.

Otherwise, the benefits of the House action on capital gains go to 327,000 taxpayers—out of approximately 66 million. Of the revenue loss, 77 percent would go to 65,000 taxpayers with incomes of over $100,000. The average cut would be almost $12,000.

And to make matters worse, the House has another gimmick for these favored few—indexing capital gains profits. Indexing simply means even more capital gains profits will escape taxation.

Over the last 10 years, the share of the tax load borne by business has gone down dramatically. Neverthless, the House bill gives business an even greater tax break. We are completely opposed to making the situation even more inequitable.

The only tax break we think business ought to get is the 5 percent credit on social security—the same reduction workers would get.

Mr. Chairman, it is our considered judgment that it is too late in this session to start anew on a program of loophole-closing reforms. But without prompt action by this committee and the Senate, the economy will be in deep trouble next year and the taxpayers will be badly hurt.

As things stand now, social security payroll taxes will increase on January 1, draining $7.4 billion out of the economy. Three tax-cutting provisions of present law will expire on December 31, resulting in a $9 billion tax increase.

Our proposal meets these problems. It provides an equitable and responsible cut in taxes for those now facing tax increases and will bolster the economy.

We therefore urge you to reject the House measure and opt for an equitable tax cut, accomplished through simply increasing the general tax credit to $150, and enacting a 5-percent social security income tax credit.

The CHAIRMAN. Thank you very much, Mr. Biemiller.

Senator Hansen?

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

The CHAIRMAN. Mr. Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Nelson?

Senator NELSON. Mr. Biemiller, in reference to your comments on the capital gains tax, I personally am in general agreement. I have forgotten the rollcall in the House, but it reflected substantial support for a capital gains reduction, as I recall.

There are, I believe, 60 sponsors of the Steiger-Hansen capital gains tax cut on the Senate side.

In view of what appears to be the reality that some capital gains adjustment cut will be made, I introduced a proposal for purposes of starting a dialog on the issue which is dramatically different from the proposal introduced on the House side and by the 60 Members on this side. That would simply provide that the first $1,500 of capital gains would be excluded for an individual and the first $3,000 of capital gains would be excluded for a couple.

So, in other words, you just deduct that first before you determine the tax.

JOINT COMMITTEE ON TAXATION

Statistics indicate that under the House bill, 327,000 people would benefit from the proposal. Under this proposal approximately 4,200,000 would benefit, with no one receiving large benefits and with 70—I believe the figure is 72 percent—of all beneficiaries in income brackets of under $50,000; 22 percent with incomes under $20,000.

If you have had an opportunity to look at that proposal or evaluate it in comparison with other pending proposals, could you comment?

Mr. BIEMILLER. We would certainly, just as an off-the-cuff opinion, prefer it to the House bill, but I sure would want to examine the whole idea very carefully and would be glad to submit to you our analysis of the bill.

Senator NELSON. I wonder if you could do that for purposes of the record as a part of your testimony.

Mr. BIEMILLER. I think your figure is a little high on the amount of people that would be affected, but that is a matter that we can check out.

Senator NELSON. I believe we obtained our figures from the Joint Committee on Taxation.

Mr. BIEMILLER. We can check that out easily enough.

Senator NELSON. Thank you.

[The following was subsequently supplied for the record:]

We have examined the proposal by Senator Nelson to provide an exclusion from gross income for the first $1,500 of net capital gains ($3,000 in the case of a joint return).

The proposal is far more equitable than either S. 3065 (Hansen-Steiger) or the major capital gains provisions contained in H.R. 13511. The Hansen-Steiger measure would cost approximately $1.9 billion; less than 400,000 taxpayers would receive any benefit and 95 percent of the revenue loss would go to taxpayers with incomes of $50,000 or more—less than 3 percent of the taxpayers.

The House provision (excluding the once-in-a-lifetime homeowner exclusion) would have a similar distributional impact benefiting only 327,000 taxpayers and providing about one-half the relief to the $50,000 and over income group.

In contrast, Senator Nelson's provision would spread benefits much more evenly. It would cost less than $1 billion and 72 percent of the relief would go to taxpayers in the $50,000 and below group.

Nevertheless, it must still be pointed out that relatively few taxpayers in the $50,000 and below group have capital gains income and therefore any measure which "liberalizes" capital gains helps very few taxpayers in those brackets. For example, the Senator's proposal, again though far more equitable than other measures we have seen, still would only benefit 3.7 million out of the approximately 65 million taxpayers in the $50,000 and below income categories or less than 6 percent of the taxpayers whereas over 30 percent of taxpayers in the $50,000 and above group would receive tax reductions.

A way, similar to Senator Nelson's provision, to limit some of the "spillover" of benefits to the wealthy would be to utilize a "phase out" technique as found in other provisions of the Code such as the Earned Income Credit. Thus, the $3,000 exclusion could phase out if either total income or income capital gains was above a certain amount. Such a measure would be much less costly and at the same time would help taxpayers whose capital gains are relatively small and represent an infrequent source of income.

The CHAIRMAN. Senator Byrd?

Senator BYRD. I have no questions.

The CHAIRMAN. Thank you very much, Mr. Biemiller. You always make a very sound statement, and we appreciate it.

[The prepared statement of Mr. Biemiller follows:]

STATEMENT OF ANDREW J. BIEMILLER, DIRECTOR, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, BEFORE THE SENATE FINANCE COMMITTEE ON THE REVENUE ACT OF 1978

1. The AFL-CIO is opposed to the grossly inequitable House bill.
2. Instead, we call for enactment of an increase in the $35 per person tax credit to $150 and a 5 percent income tax credit for Social Security payroll taxes—a total 1979 tax cut of about $21 billion.
3. Under the House bill:

   2 million taxpayers with incomes of $15,000 and under would receive a tax increase.

   Two-thirds of the total cut—or $10 billion—would go to business and those at the top of the income ladder.

   According to the Census Bureau, 60 percent of American families have incomes between $8,000 and $26,000—20 percent receive less and 20 percent receive more. For those 60 percent of families, the House bill would reduce taxes by less than $100. The AFL-CIO proposal would provide about triple that amount of relief to those families.
4. Unless Congress acts, the economy will be in deep trouble since Social Security taxes will increase next year draining over $7 billion out of the economy and tax cut provisions of existing law will expire on December 31 resulting in a $9 billion tax increase.

1979 TAX RELIEF—FAMILY OF 4—AFL-CIO PROPOSAL VERSUS HOUSE BILL

Wage or salary income	House bill	AFL-CIO
$10,000	$62	$477
$15,000	77	475
$20,000	146	481
$25,000	232	490

TABLE I.—DISTRIBUTION OF INDIVIDUAL INCOME TAX CUTS UNDER H.R. 13511 AND AFL-CIO PROPOSAL BY INCOME GROUP

Income group	Number of taxpayers (millions)	Percent of taxpayers	Amount of reduction (billions)		Average reduction per taxpayer	
			H.R. 13511	AFL-CIO	H.R. 13511	AFL-CIO
0 to $30,000	59.4	88	$5.4	$16.0	$90	$269
$30,000 to $50,000	5.8	9	2.4	2.6	400	448
$50,000 and over	1.8	3	2.5	.8	1,400	444

Note: Does not include business or capital gains reductions.

Source: AFL-CIO Research Department calculations based on Joint Committee on Taxation data.

TABLE II.—SELECTED DATA ON U.S. FAMILY INCOME 1977

Median income.—All families, $16,009. 95 percent of U.S. families received income of $40,493 or less. 80 percent of families received incomes of $26,000 or less. 60 percent of U.S. families were in the income range of $7,903 to $26,000.

	1977 Income Range
Lowest 20 percent of families	$7,903 and under.
Middle 60 percent of families	7,903–26,000.
Highest 20 percent of families	26,000 and over.
Top 5 percent of families	40,493 and over.

Source: Current Population Reports, Series P-60, No. 116. U.S. Department of Commerce, Bureau of Census, July 1978.

TABLE III.—TAX REDUCTION—SELECTED FAMILY SIZE, AFL-CIO PROPOSAL AND H.R. 13511 [1]

Wage or salary	Single		Married no dependents		Married plus 2 dependents		Married plus 4 dependents	
	AFL-CIO	H.R. 13511	AFL-CIO	H.R. 13511	AFL-CIO	H.R. 13511	AFL-CIO	H.R. 13511
$3,000	$9		$9		$9		$9	
$5,000	124	$21	15		15		15	
$6,000	107	16	[2] 133	$31	18		18	
$8,000	74	12	255	47	[2] 144	$36	25	
$10,000	42	15	225	39	[2] 477	62	[2] 159	$44
$12,500	38	38	182	14	498	105	[2] 600	88
$15,000	46	71	166	6	475	77	736	97
$17,500	54	87	174	25	474	115	744	145
$20,000	61	105	181	81	481	146	751	194
$25,000	70	160	190	160	490	232	760	300
$30,000	70	213	190	224	490	304	760	410
$35,000	70	247	190	286	490	388	760	508
$40,000	70	328	190	345	490	486	760	610
$50,000	70	436	190	474	490	654	760	821
$100,000	70	436	190	674	490	924	760	1,174

[1] Increase $35 general tax credit to $150 per dependent and a 5-percent income tax credit for social security payments. The present 2 percent of taxable income, maximum of $180 option would continue.
[2] Made nontaxable as a result of proposal.

Note: Assumes 1-earner family, all income from wages or salaries, and itemized deductions equal 23 percent of income or standard deduction, whichever is higher.

Source: AFL-CIO Research Department.

TABLE IV.—AVERAGE RATES OF PAY; SELECTED JOBS—MAJOR U.S. CITIES

State	City	Computer program, class B (weekly)	Tool die (hourly)	Maintenance machinist (hourly)	Janitor (hourly)
Alabama	Birmingham, 1978	$284.50	$7.22	$7.76	$3.03
Alaska	(1)				
Arizona	(1)				
Arkansas	(1)				
California	San Francisco, 1978	295.00	10.53	9.56	5.35
Colorado	Denver, 1977	292.50	8.00	7.36	3.48
Connecticut	Hartford, 1978	263.00	7.19	(2)	3.43
Delaware	(1)				
Florida	Miami, 1977	290.50	6.35	8.41	2.85
Georgia	Atlanta, 1977	284.50	7.47	7.19	3.01
Hawaii	(1)				
Idaho	(1)				
Illinois	Chicago, 1977	275.50	8.26	7.64	4.54
Indiana	Indianapolis, 1977	239.00	8.42	7.63	4.08
Iowa	(1)				
Kansas	Wichita, 1978	285.00	6.91	8.20	3.36
Kentucky	Louisville, 1977	258.00	8.20	8.03	3.61
Louisiana	New Orleans, 1978	276.50	(2)	8.05	2.93
Maine	Portland, 1977	270.50	5.60	5.23	4.26
Maryland	Baltimore, 1977	281.00	7.93	7.84	3.24
Massachusetts	Boston, 1977	263.50	7.08	6.68	3.62
Michigan	Detroit, 1978	335.00	9.31	9.01	5.49
Minnesota	Minneapolis, 1978	285.50	8.24	8.11	4.26
Mississippi	Jackson, 1978	232.50	(2)	6.65	2.89
Missouri	St. Louis, 1978	281.50	8.74	8.24	4.22
Montana	(1)				
Nebraska	Omaha, 1977	280.00	(2)	7.56	3.21
Nevada	(1)				
New Hampshire	(1)				
New Jersey	Newark, 1977	281.50	7.18	6.89	3.61
New Mexico	(1)				
New York	New York, 1977	306.50	6.81	7.76	5.05
North Carolina	(1)				
North Dakota	(1)				
Ohio	Cleveland, 1977	303.50	8.19	7.52	4.30
Oklahoma	Oklahoma City, 1977	301.00	7.21	6.79	2.60
Oregon	Portland, 1977	240.50	8.09	8.00	4.35
Pennsylvania	Philadelphia, 1977	289.00	7.39	7.70	4.40
Rhode Island	Providence, 1977	230.50	6.41	5.85	3.35
South Carolina	Greenville, 1977	262.00	5.49	5.29	2.97
South Dakota	(1)				
Tennessee	Memphis, 1977	275.00	7.18	7.72	2.98
Texas	Dallas, 1977	256.00	7.43	6.89	3.00
Utah	Salt Lake City, 1977	272.50	6.64	7.31	3.31
Vermont	(1)				
Virginia	Richmond, 1977	256.50	(2)	7.47	3.27
Washington	Seattle, 1977	317.00	(2)	8.73	4.71
West Virginia	(1)				
Wisconsin	Milwaukee, 1978	295.50	8.58	9.34	4.13
Wyoming	(1)				

1 Data either not available or not current.
2 Occupational data not available.

Source: U.S. Department of Labor, Bureau of Labor Statistics, area wage surveys.

The CHAIRMAN. Next, we will call Mr. John Dale Davidson, chairman of the National Taxpapers Union.

Senator BYRD. If you would yield to me just a moment, I might say that the National Taxpayers Union has done a tremendous job in persuading the legislatures of 22 States to approve the calling of a national convention to amend the Constitution to require a Federal balanced budget, and I am happy to take this opportunity to commend Mr. Davison and Mr. Baldwin—Mr. Baldwin being from Virginia and the city of Alexandria—for what they have done in this regard.

Senator CURTIS. Mr. Chairman, I will endorse what Senator Byrd has said.

STATEMENT OF JAMES DALE DAVIDSON, CHAIRMAN, NATIONAL TAXPAYERS UNION AND DONALD BALDWIN, ASSISTANT TO THE CHAIRMAN AND LEGISLATIVE DIRECTOR, NATIONAL TAXPAYERS UNION

Mr. DAVIDSON. Thank you.

Mr. Chairman, in the interests of brevity, I am going to emphasize only certain portions of my statement and I hope that the rest will be included in the full record.

I am James Davidson, representing the National Taxpayers Union. We have 70,000 individual contributions who support our national effort and we have several thousand corporate members. In addition, we have State-affiliated groups in all 50 States. In the State of New York, we have 260 groups alone, so we represent more than a million taxpayers organized in various groups throughout the country.

It is my feeling that the members of this committee and the current Congress as a whole have a unique opportunity to revitalize America. Tax reductions, oriented toward increased production, will not only enhance the tangible output of America's farms and factories, they will encourage America's demoralized taxpayers and, if properly formulated, could be a substantial step toward remedying the underlying weaknesses in America's position in the world economy.

Certainly, we cannot be unaware that there is a need for change in the government's tax policy toward investment. For too long, tax experts have been preoccupied with a nearsighted attention to the incidence of taxation rather than considering how tax policies affect economic growth.

We have just heard several estimates as to whether 3,000 people would benefit, or millions would benefits from a changed tax law. It seems to me, Mr. Chairman, that the problem is much greater than that. If we improve productivity in this country, everyone would benefit, and that is what we are here to recommend.

In the past, the attempts to focus on the incidence of taxation has resulted in changes in tax laws and the tax burden has become extremely progressive. The top 10 percent of the income earners paid almost 50 percent of personal income taxes in 1975 and the top 50 percent of income earners paid almost 93 percent of the total bill.

Clearly, America's more economically productive citizens are being heavily taxed. This would appear to be unexceptional. The income tax systems in most western countries are "progressive;" the more an individual earns, the more he pays in taxes. In actual practice, however, the variances in tax structures from country to country correlate closely with rates of economic growth. While other western countries have distinguished between capital gains and income, thus providing the needed incentive to investment and a route for ambitious individuals to accumulate wealth, the United States has coupled a high progressive income tax system with punishing capital gains levies. The result has been a burden which people in fast-growing economies do not have to bear.

Americans pay a staggeringly high capital gains tax. Even such notoriously overtaxed peoples as Englishmen and Swedes have capital gains burdens 40 to 50 percent lower than Americans. In Great

Britain, the first £1,000 of gains are tax free. Up to £5,000, the capital gains rate is only 15 percent. Thereafter, the gains are taxed at a maximum rate of 30 percent.

The Germans, Japanese, French, Italian, Swiss, and most other western people pay virtually no capital gains taxes. The ability to realize gains in capital value is the crucial incentive which must be present to justify the risk of involvement. Even in the Keynesian formulation, where the emphasis is heavily weighted toward consumption as an index of economic well-being, there is a crucial connection to generate further production: inventors and businessmen expand capacity in order to realize increased value of greater capital assets. The incentive to invest and improve productive capacity is eliminated however, if there is no probability of realizing a capital gain.

The high capital gain taxes which are almost unique to America among western countries, make investment in the American economy less attractive than investment abroad. While our competitors operate on the basis of rewarding risk and investment, America's tax policy has become something ventured, nothing gained.

As inflation accelerates, the destructive impact of high capital gains taxes is worsened. Under current conditions, your assets would have to double in 6 years, triple in 10 years, and quintuple in 16 years for you just to stay even. This effectively guarantees that the average American will never increase his wealth.

Harvard economist Martin Feldstein has shown that in one recent year investors with incomes of less than $100,000 paid an average effective capital gains rate of over 100 percent. No wonder 6 million small investors have dropped out of the capital markets since capital gains taxes were doubled in 1969.

Even under the most favorable tax conditions, investment in productive activity is risky. According to the latest thorough study of the behavior of stock prices all the way back to 1910 the real average return over that span of years was only 1.6 percent. The authors of the study, Professor Robert Soldofsky, professor of finance at the University of Iowa, and Dale Max, associate professor of Finance at Governors State University in Illinois, show that stock prices consistently failed to maintain their value with inflation.

In order to reattract small investors into the stock market and broaden the base of ownership in America, it is necessary to learn from our competitors, especially in Germany and Japan, and slash capital gains taxes.

It is no secret that America is not the economic leader it should be. Every year, the situation worsens. Our balance-of-payment deficit expands. We have less investment. Slower growth. Smaller increases in productivity. Every American pays for this through a lower standard of living. If the American economy had grown as fast as the German and Japanese economy over the past 25 years, the average American would be 50 percent richer today. He would have a better job. He would live in a better house. He would produce a better product. The chances are high that with increased capital investment especially in new, emerging enterprises, the average American would produce more goods of a quality which he would want to buy.

For a long time, we have failed to face up to the fact that America is not meeting the challenge of foreign competition. We have been told

that the dollar's precipitous decline against the major western currencies is the result of dependence upon foreign oil. Yet, without gainsaying the importance of action to release the hampered productive capability of American's energy sources, we cannot be fooled by the notion that our balance of payments deficit is due to energy costs. Japan and Western Germany import all of their oil, yet they have large trade surpluses. Indeed, in spite of a 13 percent decline in U.S. oil imports over the past year, the dollar has nevertheless fallen more than 40 percent against the Japanese yen alone.

Our real problem is not that we are buying oil, but that we are not manufacturing enough products that even we want to buy. Our capital plant is becoming increasingly antiquated. We have excess capacity in many out of date factories—which gives us the ability to produce more of what the world does not want. We need substantial capital investment, not only in existing business corporations, but in new businesses with new management working to implement new ideas so that our capital plant can once again be appropriate to produce high quality goods that Americans and other people want to buy.

We have alibied our shortcomings long enough. The rapid decline in the dollar tells us that we will no longer be able to live beyond our means by printing money and exporting our deficits to other nations.

If we hope to avoid a rapid decline in our standard of living, which has been predicted for us and is now clearly on the horizon, we must slash capital gains taxes to provide greater scope for risk-taking and profit in the private sector.

The primary advantage of capital gains tax reduction is to allow the accumulation of capital in new enterprises. As part of our national tax reduction plan, National Taxpayers Union also advocates substantial tax reductions for individuals and existing corporations. While we are not wedded to any particular proposal, the plan advocated by Senator Roth to reduce personal income tax rates by about 33 percent over a 3-year period and to reduce the maximum rate for corporations to 45 percent has much to commend it.

Such tax reductions are necessary to offset the effects of inflation in boosting individuals into ever higher brackets. Without action to slash tax rates, by the year 2000 a typical husband and wife with two children, filing a joint return, will pay an extra $43,916—in current dollars—in Federal income taxes.

This production is out of date because it is calculated on the assumption of 6.3 percent annual inflation, which we have not been able to beat.

We need genuine tax reduction now coupled with spending cuts to balance the Federal budget. This would shift the prospects for adventure back into the private sector and reward work, growth, investment, productivity, and savings. This would renew the American dream, open up the vistas of opportunity so that America can regain its place as the strongest economy in the world. But it is not merely a matter of economics.

The genius of America has always been that this was the place where a man or a woman could rise as far as his human character would take him. We must restore that by making the rewards for hard work once again sufficient to the risks so that any enterprising nobody can still come along, imagine something impossible, and attain it.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Mr. Davidson, you have made a splendid statement. You have emphasized something that this committee must keep in mind, and that is, what is the economic effect of a tax reduction? It goes far beyond just who gets how many dollars.

You have placed the proper amount of stress on job creation and capital expansion and I commend you for it.

Do you believe that when jobs are plentiful that that is the time when there is opportunity for the young who have never had a job to get one, and for the unemployed and for the underemployed?

Mr. DAVIDSON. It is quite obvious.

Senator CURTIS. So that the effect of a proposed tax action in reducing unemployment—must be taken into account. Is that not correct?

Mr. DAVIDSON. I think that is correct. If I could emphasize what I said in the testimony, in Europe, where there have been Socialist governments in power in such countries as Holland and Germany for many years, they have steadfastly opposed introducing any capital gains tax, for example, because they recognize that the prospects for growth, employment, maintaining a strong position in the world's economy depend upon providing some incentives to somebody, someplace to take a risk.

Senator CURTIS. Yes.

While it might be pointed out that another type of tax reduction would give x dollars to someone who is unemployed, they are much worse off than if we take action that gives them a job. Is that not correct?

Mr. DAVIDSON. That is quite true. Look at the record. The record shows that if we had grown, for whatever reason, as fast as the Japanese had, the average American would be 50-percent richer today. He would work in a better job, he would be better paid, and we would not be running these fantastic budgets here in Washington. We would not have to worry, and this committee would not have to wrestle with the difficulties of protectionist legislation, and so forth, to try to shore up failing businesses because we cannot meet the challenge of competition from areas where people are investing two or three times as much of their total income as we are.

Senator CURTIS. Our staff here called my attention to the fact that there was a time when about 1 American out of 3 made his living in manufacturing and now it has dropped to a mere 1 out of 4.

That is not a good sign so far as our balance of trade or our job opportunities, is it?

Mr. DAVIDSON. No, sir. We do not make very much in this country today that people in the rest of the world want to buy; outside of our computers, our airplanes and some of our automobiles, it is very difficult to find something that we manufacture that is competitive.

If you look in a department store, you cannot find a toaster made in the United States, or probably a television. It is a sad situation.

Senator CURTIS. Your statement is so good, and I could spend a lot of time on it, but it speaks for itself. I would emphasize this point, that the Congress must look to the question of who will benefit as a result of this tax act, and I think that you have put your finger on it.

When we give capital gains tax relief, when we do those things to encourage capital investment, we are helping to create jobs which benefits those who are most unfortunate; those who have no income.

Mr. DAVIDSON. Yes, sir.

Senator CURTIS. I thank you for your appearance.

Mr. BALDWIN. Mr. Chairman, I do not know whether Mr. Davidson asked permission or not——

The CHAIRMAN. Pardon me, sir.

The Senate is now calling the names of absentees on a rollcall vote. I must go vote. I will be back as soon as I can. Senator Byrd may be back before I am and if he does I think he wants to ask you a question. On his behalf, I would suggest you just stay where you are and we will stand in recess until another Senator gets back in here. We will all be back as soon as we can.

[A brief recess was taken.]

Senator CURTIS. The committee will come to order. Senator Byrd has some questions and he will be here momentarily.

Mr. Davidson, in your statement, you say: "Under current conditions a person's assets would have to double in 6 years, triple in 10 years, and quintuple in 16 years, just to stay even."

Mr. DAVIDSON. That is right.

Senator CURTIS. Can you be more specific about what you mean by "current conditions?"

Mr. DAVIDSON. Yes; Senator.

By current conditions, I am talking about the inflation rate which has persisted on an average since the beginning of this decade and the current tax laws, so when you figure it out, it is almost impossible for someone to maintain his total wealth let alone be moving forward.

I think one of the things that has been missed in this great shuffle to decide who has been paying the tax rate is that only income, not wealth, can be adjusted. You can have an index on your income to supposedly keep pace with inflation even though you are going into a higher tax bracket and your net return is less. What is missed is that a person's overall wealth is declining.

Ever since inflation went over 2.5 percent, the best investment that people could make was to buy a private home. While it is perfectly wonderful to have people buying a private home, and that is a part of the American dream as much as anything else, you have to also consider that it has to be worth your while, sometime, to invest in something productive.

The American people are very good economizers and when you reach a situation where it does not make any sense to take a risk and invest in productive enterprise, you find people moving out of productive enterprise and putting their money into diamonds and antique cars, and gold, which we hear is going up constantly. This is a great mistake if we are as concerned as I am sure members of this committee are, about the individual trying to make it and who does not have anything.

The guy starting off without a job, without any skills whatever, he is going to have an extremely uphill fight under the current conditions. This is why we recommend decreasing the capital gains tax.

Senator CURTIS. Thank you very much.

The CHAIRMAN. Senator Byrd?

Senator BYRD. I have no questions.

The CHAIRMAN. Thank you very much, sir.

Senator NELSON. Mr. Chairman, I wonder if I could ask one?

The CHAIRMAN. Senator Nelson?

Senator NELSON. I notice that on page 2 of your testimony you make reference to Harvard economist Martin Feldstein's statement that in one recent year, investors with income of less than $100,000 paid an average effective capital gains rate of over 100 percent.

Then you state, no wonder 6 million small investors have dropped out of the capital market since capital gains were doubled.

How did these investors get to a tax rate of over 100 percent?

Mr. DAVIDSON. Very easily. The effect is this.

If you buy a stock in 1962 when the dollar was worth double what it is today or more, and you kept it, and that is your base year and sell it in 1973, which was the base year for this study, to obtain the same purchasing power you would have to have had to doubled your money.

Senator NELSON. Offseting inflation, is that what you are talking about?

Mr. DAVIDSON. If you are talking about your real purchasing power, which is what people are concerned about, you are paying an effective rate of over 100 percent in most cases, especially the average investor. People are concerned about what their actual effective spending power is, because the old adage that you save now, you postpone consumption now, in order to consume more in the future has been reversed. If you postpone consumption now, you consume less in the future.

Senator NELSON. Your next statement is that 6 million small investors have dropped out of the capital markets. Under the House bill, the figures we have indicate that over 90 percent of all of the benefits go to individuals with incomes over $50,000.

In the stock market, as I understand it, of the some 20 million investors, 62 percent of them have holdings of $10,000 or less, 62 percent of that 20-some million.

My query relates, is to the one I raised with Mr. Biemiller concerning the bill, S. 3410, which would discount the first $1,500 of capital gains for an individual and the first $3,000 for a couple. Under that proposal, approximately 72 percent of all the benefits would go to people under $50,000 instead of 90 percent to people over $50,000, as in the House bill.

Would that not better meet the problem of the 6 million small investors who dropped out of the market, most of whom are way under the $50,000 income?

Mr. DAVIDSON. If I may answer this in a somewhat different fashion, the reason that most of the benefits would fall purportedly to people in the higher brackets is the way these figures are compiled. If someone goes back into the current tax laws, looking at the returns filed last year or the year before and says, OK, if this law had been in effect last year and everyone had done everything the same, then the benefits would have fallen to people in the higher brackets.

In part of my testimony, which I did not read, I indicated that one of the peculiarities of the current tax law is that it makes it actually more expensive for someone with a lower income to have a capital gain than someone with a higher income. If I might read from this, this might clarify it.

Because of the minimum tax provision and the rate of 15 percent, the minimum tax applies after an exemption of only $10,000, or one-

half the taxpayers' regular tax or income tax. The result is that the minimum tax on capital gains is higher for a lower income person with a smaller regular tax than it is for a higher person with a higher tax.

In other words, a taxpayer with $25,000 of regular income pays 135 percent of the minimum tax of a taxpayer of $75,000 of regular income, if they both have an equal capital gain.

If the laws were changed in the way we suggest, then the average individual who, under the current conditions, has no incentive to arrange his financial affairs in a way that would show up under the current statistics, would begin to have an incentive and the benefit would be greater to the average person under the House-passed bill.

Senator NELSON. Thank you.

The CHAIRMAN. Thank you very much, sir.

[The prepared statement of Mr. Davidson follows:]

TESTIMONY OF JAMES DALE DAVIDSON, CHAIRMAN, NATIONAL TAXPAYERS UNION

Mr. Chairman, I am James Dale Davidson, Chairman of the National Taxpayers Union, headquartered in Washington and representing individual taxpayers throughout the country. We have over 70,000 dues-paying members and several thousand corporate members. Through our affiliate members in the 50 states NTU represents easily the largest number of taxpayers of any national organization.

Mr. Chairman, the members of this committee and the current Congress as a whole, have an unique opportunity to revitalize America. Tax reductions, oriented toward increased production, will not only enhance the tangible output of America's farms and factories, they will encourage America's demoralized taxpayers and, if properly formulated, could be a substantial step toward remedying the underlying weaknesses in America's position in the world economy.

Certainly, we cannot be unaware that there is a need for change in the government's tax policy toward investment. For too long, tax experts have been preoccupied with a near-sighted attention to the incidence of taxation rather than considering how tax policies affect economic growth as a whole. The result has been a redistribution of the tax burden so that the top ten percent of income earners paid almost 50 percent of personal income taxes in 1975. The top 50 percent of income earners paid almost 93 percent of the total tax bill. Clearly, America's more economically productive citizens are being heavily taxed. This would appear to be unexceptional. The income tax systems in most western countries are "progressive," the more an individual earns, the more he pays in taxes. In actual practice, however, the variances in tax structures from country to country correlate closely with rates of economic growth. While other western countries have distinguished between capital gains and income, thus providing the needed incentive to investment and a route for ambitious individuals to accumulate wealth, the United States has coupled a high progressive income tax system with punishing capital gains levies. The result has been a burden which people in fast-growing economies do not have to bear.

Americans pay staggeringly high capital gains taxes. Even such notoriously over-taxed peoples as Englishmen and Swedes have capital gains burdens 40-50 percent lower than Americans. In Great Britain, the first £1,000 of gains are tax free. Up to £5,000, the capital gains rate is only 15 percent. Thereafter, the gains are taxed at a maximum rate of 30 percent. The Germans, Japanese, French, Italian, Swiss, and most of the western people pay virtually no capital gains taxes.

The ability to realize gains in capital value is the crucial incentive which must be present to justify the risk of investment. Even in the Keynesian formulation, where the emphasis is heavily weighted toward consumption as an index of economic well-being, there is a crucial connection to generate further production: investors and businessmen expand capacity in order to realize increased value of greater capital assets. The incentive to invest and improve productive capacity is eliminated however, if there is no probability of realizing a capital gain.

The high capital gains taxes which are almost unique to America among western countries, make investment in the American economy less attractive than investment abroad. While our competitors operate on the basis of rewarding risk and investment, America's tax policy has become something ventured, nothing gained.

As inflation accelerates, the destructive impact of high capital gains taxes is worsened. Under current condtions, your assets would have to double in six years, triple in ten years, and quintiple in 16 years for you just to stay even. This effectively guarantees that the average American will never be able to increase his wealth. Harvard economist Martin Feldstein has shown that in one recent year investors with incomes of less than $100,000 paid an average effective capital gains rate of over 100 percent. No wonder six million small investors have dropped out of the capital markets since capital gains taxes were doubled in 1969.

Even under the most favorable tax conditions, investment in productive activity is risky. According to the latest thorough study of the behavior of stock prices all the way back to 1910 the real average return over that span of years was only 1.6 percent. The authors of the study, Professor Robert Soldofsky, Professor of Finance at the University of Iowa, and Dale Max, Associate Professor of Finance at Governors State University in Illinois, show that stock prices consistently failed to maintain their value with inflation.

In order to reattract small investors into the stock market and broaden the base of ownership in America, it is necessary to learn from our competitors, especially Germany and Japan, and slash capital gains taxes.

One of the first consequences of such a reduction would be to increase the funds available for the financing of new, emerging enterprises. Job creating industries need risk investment. The entire economy profits from an increase in entrepreneurial activities. It gives our way of life diversity and flexibility, not only creating new jobs and innovation, by making available constructive outlets for people with talent and enterprise. The only alternative to seeing our economy become more stagnate and increasingly dominated by large business complexes, bigger government, large banks and other financial institutions is for Congress to lift the tax barriers to new business. By lowering capital gains taxes to a maximum of 25 percent the Congress would be placing new competitive enterprise in the position to compete in the capital markets with established corporations paying dividends and with bonds and other debt instruments guaranteed by the taxing power of government.

National Taxpayers Union commends to this committee the desirability of eliminating capital gains transactions from the minimum tax. As it now stands, the minimum tax has the effect of making capital gains transactions more costly to middle income investors than to those in the highest brackets. At a rate of 15 percent, the minimum tax now applies after an exemption of only $10,000 or one half the taxpayer's regular tax or income tax. The result is that the minimum tax on capital gains is higher for a lower income person with a smaller regular tax than it is for a higher income person with a higher tax. In other words, a taxpayer with $25,000 of regular income pays 135 percent of the minimum tax of a taxpayer with $75,000 in regular taxable income if they each have an equal capital gain. By lowering the minimum tax deduction from $30,000 to $10,000 in 1976, Congress required that a lower income taxpayer pay a higher capital penalty on the same transaction than someone earning 3 times his income. This inequity could be simply eliminated by excluding capital transactions from the minimum tax provision.

It is no secret that America is not the economic leader it should be. Every year, the situation worsens. Our balance of payment deficit expands. We have less investment. Slower growth. Smaller increases in productivity. Every American pays for this through a lower standard of living. If the American economy had grown as fast as the German and Japanese economy over the past 25 years, the average American would be 50 percent richer today. He would have a better job. He would live in a better house. He would produce a better product. The chances are high that with increased capital investment especially in new, emerging enterprises, the average American would produce more goods of a quality which he would want to buy.

For a long time, we have failed to face up to the fact that America is not meeting the challenge of foreign competition. We have been told that the dollar's precipitous decline against the major western currencies is the result of dependence upon foreign oil. Yet, without gainsaying the importance of action

to release the hampered productive capability of America's energy sources, we cannot be fooled by the notion that our balance of payments deficit is due to energy costs. Japan and Western Germany import all of their oil, yet they have large trade surpluses. Indeed, in spite of a 13 percent decline in U.S. oil imports over the past year, the dollar has nevertheless fallen more than 40 percent against the Japanese yen alone.

Our real problem is not that we are buying oil, but that we are not manufacturing enough products that even we want to buy. Our capital plant is becoming increasingly antiquated. We have excess capacity in many out of date factories—which gives us the ability to produce more of what thet world does not want. We need substantial capital investment, not only in exitsing business corporations, but in new businesses with new management working to implement now ideas so that our capital plant can once again to appropriate to produce high quality goods that Americans and other people want to buy.

We have alibied our shortcomings long enough. The rapid decline in the dollar tells us that we will no longer be able to live beyond our means by printing money and exporting our deficits to other nations.

If we hope to avoid a rapid decline in our standard of living, which has been predicted for us and is now clearly on the horizon, we must slash capital gains taxes to provide greater scope for risk taking and profit in the private sector.

The primary advantage of capital gains tax reduction is to allow the accumulation of capital in new enterprises. As part of our national tax reduction plan, National Taxpayers Union also advocates substantial tax reductions for individuals and existing corporations. While we are not wedded to any particular proposal, the plan advocated by Senator Roth to reduce personal income tax rates by about 33 percent over a three year period and to reduce the maximum rate for corporations to 45 percent has much to commend it. Such tax reductions are necessary to offset the effects of inflation in boosting individuals into ever higher brackets. Without action to slash tax rates, by the year 2000 a typical husband and wife with two children, filing a joint return, will pay an extra $43,916 (in current dollars) in federal income taxes. (This projection is calculated on the optimistic assumption of 6.3 percent annual inflation.)

We need genuine tax reduction now coupled with spending cuts to balance the federal budget. This would shift the prospects for adventure back into the private sector and reward work, growth, investment, productivity and savings. This would renew the American dream, open up the vistas of opportunity so that America can regain its place as the strongest economy in the world. But it is not merely a matter of economics. The genius of America has always been that this was the place where a man or a woman could rise as far as his human character would take him. We must restore that by making the rewards for hard work once again sufficient to the risks so that any enterprising nobody can still come along, imagine something impossible, and attain it.

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APPENDIX A

THE INFLATION TAX RIPOFF

Year	Income	Taxable income	Tax	Tax in constant dollars
1977	$17,763	$11,563	$2,167	$2,167
1978	18,882	12,682	2,429	2,285
1980	21,336	15,136	3,041	2,532
1985	28,959	22,759	5,267	3,228
1990	39,305	33,105	9,124	4,123
1995	53,348	47,148	15,634	5,206
2000	72,407	66,207	25,634	6,289
Taxes paid (in constant dollars) with inflation				$95,924
Taxes paid (in constant dollars) if no inflation				52,008
Inflation-tax overcharge				43,916

By the year 2000, a typical American family may lose thousands of tax dollars to the Federal government. If the current tax schedule is not indexed for inflation, and inflation continues at its current pace, a typical husband and wife with two children, filing a joint return, will pay an extra $43,916 in taxes to the government.

Since 1970, the Consumer Price Index has risen at an annual rate of 6.3 percent. If this rate is maintained, Americans will have to earn an extra 6.3 percent every year, just to keep pace with inflation. But today's archaic tax system will penalize these families.

According to the most recent figures available, a typical husband and wife filing a joint return had $11,500 in taxable income. If they had two children, and claimed standard deductions as laid out in the most recent tax laws, this would give them an annual income of about $17,700. To achieve this same living standard, their pre-tax income would have to rise 6.3 percent each year. The "Income" column lists these figures. The "Taxable Income" column lists their income subject to tax, if they continue to take the standard deductions. The "Tax" column shows how much they would owe in Federal income taxes.

Of course, to find out what those tax dollars are worth at today's prices, they should be deflated by the appropriate 'inflation factor." These figures are shown in the last column above.

Notice that both the "Tax" and the "Tax In Constant Dollars" figures rise. Even though the family is no better off, the federal government takes a larger and larger chunk of taxes each year.

With each passing year inflation pushes the taxpayer into higher and higher tax brackets. With each passing year, the government receives more and more tax revenues. To eliminate this "money grab", the income tax schedules should be indexed for inflation.

APPENDIX B

SOCIAL SECURITY AND FEDERAL EMPLOYEES

Any proposal for correcting the Social Security financial problems that fails to include all workers in the plan (contributions as well as benefits) should not be considered. In particular, failure to include federal empoyees in the plan's contributions provisions (they already receive its benefits) assures an ever-increasing tax-load on private workers and their employers while assuring federal employees of an ever-increasing preferred economic status.

The following wage, tax, and cost of living information of private workers and federal employees for the ten-year period (1967–1977) shows the comparative changes in gross wages and "real" income of the two classes of workers:

COMPARATIVE WAGE GAIN OR (LOSS) OF PRIVATE (NONFARM) WORKERS AND FEDERAL EMPLOYEES: 1967–77 (SEE APP. I)

	1967	1977	Percent change
Private (nonfarm) wages:			
Average annual wage	$5,295.68	$9,595.56	+81.2
Less: Social security tax	233.00	561.34	+140.9
Less: Income tax (Federal)	348.58	839.68	+140.9
Spendable wage	4,714.10	8,194.54	+73.8
Cost of living (times 179.6)	4,714.10	8,466.52	+79.6
Gain or (loss) "real" income	0	(−271.98)	−5.8
Federal employees salary:			
Average annual salary	8,355.00	17,300.00	+107.1
Less: Social security tax	0	0	0
Less: Income tax (Federal)	832.61	2,195.10	163.6
Spendable salary	7,522.39	15,104.90	+100.8
Cost of living (times 179.6)	7,522.39	13,510.21	−79.6
Gain or (loss) "real" income [1]	0	+1,594.69	+21.2

[1] Calculations for "real" income.

Notes: Average weekly wage is for April 1977.

Private wages increased about the same as prices over the period, with one increase simply off-setting the other. However, since taxes increased at a much faster rate (almost double) than wages or prices, workers' living standards declined by almost 6 percent. The same is not true for the federal employee. Although his income tax increased proportional to his increased income, and the prices he paid increased at the same rate as for private workers, the fact he paid no Social Security taxes (combined with an extraordinarily high salary increase) allowed federal employees to increase their living standard over 20 percent. The combination of "double-indexing" federal salaries for wage increases, i.e., once on "comparability" to assure private-public wage parity and once for "cost of living" increases, plus the exemption from dedicated wage taxes, e.g., Social Security, means that the public (gross) salary always increases at about twice the rate private wages increase and "real" federal wages (gross wages adjusted for tax and price changes) increase at an event faster rate. Federal salaries should be "tied" to the private wage index and not the price index. Certainly not both! In addition, Federal employees should, as should all workers, come under full participation of the Social Security plan. All workers should contribute to the plan, and all retired workers should benefit from the plan. That would be simple, easy to administer, and fair to all workers.

Some arguments for bringing federal workers into a "universal" Social Security program are:

1. Federal employees now receive Social Security benefits yet they pay no taxes into the fund. For example, in 1973, almost 30 million persons received retirement (18.7 m), disability (3.4 m) and survivor benefits (7.0 m) from Social Security. However, there were only about 21 million people over age 65 in the U.S. in 1973. It is true that some of these beneficiaries were under age 65 (women who retire at 62, surviving spouses, children, etc.), it is unlikely that the number exceeds 25 percent of the total, which means that everybody over age 65 draws Social Security retirement benefits. News accounts indicating that between 75–80 percent of all retired federal workers receive Social Security benefits appears valid. If but 75 percent of the 1.6 million retired federal workers received Social Security benefits of $2,400 each in 1977, the unfunded cost to Social Security was $2.9 billion ($2,400×0.75×1,600,000).

2. In 1977, the Social Security tax rate was 5.85 percent on wages up to $16,500. If but 80 percent of the federal salary of $17,300 had been, on the average, subject to Social Security taxes, the typical salary on which the Social Security tax rate would have applied would have been (0.80×$17,300) $13,840. Thus, the average contribution by each government worker would have been ($13,840×5.85) $809.64. In April 1977, there were 2,721,000 federal workers. If each had paid $809.64 in Social Security taxes, the direct salary contribution by federal workers would have been $2.2 billion, with an equal amount "matched" from general revenues, for a total 1977 contribution of $4.4 billion. Since the current "shortfall" in Social Security is about $4.0 billion, the inclusion of federal employees in the Social Security program in 1977, and in future years, would fairly balance the program and avoid the necessity of adding higher Social Security taxes to modestly paid private workers while excluding the better paid federal employees from this tax.

3. The historical practice of off-setting higher Social Security taxes through a reduction in individual income taxes is another example of "double" benefits accruing to government employees. Government employees pay no Social Security taxes and as a result their salaries are not affected by increases in this tax. However, they receive the same tax benefits from a downward adjustment in individual income taxes that covered workers receive.

4. The overall growth, and relative differentials, in private wages and federal salaries from 1955 to 1977 has been:

Year	Average Federal salary	Average private wage	Percent difference
1955	$4,286	$3,521	+21.7
1960	5,450	4,195	+29.9
1965	7,097	4,943	+43.6
1970	9,755	6,212	+57.0
1975	14,230	8,522	+70.0
1977	17,300	9,595	+80.3

In 1955 federal workers were paid about 22 percent more than private workers, and in 1977 they were paid about 80 percent more. The very fact that Social Security exempt wages have increased at almost twice the rate non-exempt wages have increased is a partial explanation for the current Social Security dilemma. Social Security benefits (transfer payments) and federal salaries are increased on the same basis (changes in private wages and consumer prices) with the consequent pay-out always increasing at twice the rate of pay-in. The not too profound conclusions to be drawn from this is that Social Security taxes must always increase by at least the combined rate wage and price increase just to keep the fund in balance. Since private wages increase only by the amount prices increase, "real" wage and private workers will always decrease in direct proportion to increased wage taxes. It would seem sensible, therefore, to adjust all transfer payments and federal salaries on changes reflected in the private wage index and not on changes in the price index.

5. The following comparative changes in various economic measurements between 1955 and 1977 is good indication of the relative gains made by private and public workers:

	1955	1977	Percent change
Federal salaries	$4,286	$17,300	+303.6
Private wages	$3,521	$9,595	+172.5
Consumer Price Index	80.2	179.6	+123.9
Private (social security) tax	$70.42	561.30	+697.1

Note: Social security Tax rate 2 percent in 1955; 5.85 percent in 1977.

The increase of 303.6 percent in federal salaries is roughly equal to the combined private wage and price increase of 172.5 percent and 123.9 percent (about 296.4 percent which tends to support the "double-indexing" theory of giving raises to federal workers. The increase of almost 700 percent in private workers Social Security tax is not a financial burden borne by the federal worker, however. This is the exclusive province of the lesser paid private worker.

If recommendations along the following lines were enacted, the Social Security problems could be curtailed with the least financial impact on the least number of people:

1. Federal workers should be required to participate in the Social Security program with "matching" funds paid from general revenue funds. (Whether a compensating adjustment should be made in funding the federal employees' regular retirement program from general revenue or not is a separate issue.)
2. Increases in federal salaries and changes in Social Security benefits (transfer payments) should conform to changes in the private wage index and not to changes in the price index. This would be far less inflationary, would assure stable public-private wage growth and would always assure that Social Security funds payments, on a per capita basis, could reasonably be related to the funds income.

The alternative to the above is to go to a truly "unified" budget and do away with the individual income tax and Social Security tax and have a simple, straightforward "across the board" income tax on everybody. Budgetary expenditures, transfer payments, as well as Government operating costs, could be allocated against this single fund. This would eliminate the question of why federal salaries (elective as well as appointive) can be increased through general revenue but support of the national pension program cannot be.

The CHAIRMAN. Next, we will call Mr. Henry Fowler, former Secretary of Treasury, former Under Secretary, known well to this Committee.

Mr. Fowler, I have read your statement before you appeared this morning. I was so impressed by it that I have not interrogated the other witnesses to save a little time that I could yield to you.

I saved an extra 5 minutes for your statement this morning, so you have 15 minutes.

Senator HANSEN. Mr. Chairman, if it would be helpful, let me say that I have not had the pleasure of reading the statement yet, but I do have a very high regard for the Secretary and I appreciate the distinguished career that he has had in public service. I should like if he needs the time, to yield my 5 minutes.

Mr. FOWLER. Thank you very much.

Senator BENTSEN. Mr. Chairman, if I might add, I have a high respect for the Secretary. My problem is that I have a major amendment affecting my State in another committee and I am going to have to be over there, and I am going to take his statement with me.

Mr. FOWLER. Much of what I have to say will not be new, because I have heard Senator Bentsen saying much the same thing.

The CHAIRMAN. Please go ahead.

Mr. FOWLER. If I may ask that my statement in full be placed in the record, I will omit certain portions of it as I move along.

STATEMENT OF HENRY H. FOWLER, FORMER SECRETARY OF THE TREASURY

Mr. FOWLER. First, let me make clear, that I am here only speaking for myself and not for any organization.

My service that you refer to, as Under Secretary and general deputy to Treasury Secretary Douglas Dillon included a very major involvement in working within the Treasury and the administration and with the Congress and its committees on the formulation and enactment of the tax programs of the early sixties. These included President Kennedy's Tax Messages of April, 1961 and January 1963 and the enactment by Congress of the Revenue Act of 1962 and the Tax Reduction Act of 1964.

You will recall that, because you, Chairman Long, handled the floor in the Tax Reduction Act in 1964, in addition to many detailed changes in the tax code that are generally regarded as tax reforms, these measures included the initial passage of the investment tax credit and the largest reduction in history of the rates of taxation on personal and corporate income taxes.

Despite the successful enactment, with some minor modifications, of President Kennedy's recommendation for reduction in personal and corporate income tax rates, we failed to secure the passage of one of his key recommendations for a substantial reduction in the taxation of capital gains. That brings me to the thrust of my statement which deals with that piece of unfinished business.

I might say, the Kennedy package for reducing capital gains, died in the House, not on this side of the Capitol.

The main purpose of my statement is simple and limited. It is to urge that the Congress, in its attempt to rectify the proven damage done to our system of capital gains taxation by the Tax Act of 1969, amend the House bill to include the adoption of a proposal for reduction in taxation of long term caiptal gains advanced by President John F. Kennedy in his tax message of January 4, 1963, which, as I have noted, was not adopted.

He recommended that, in addition to enacting major reductions in the rates of taxation on personal and corporate income, the Congress should: "Reduce the percentage of long term capital gains included in individual income subject to tax from the present 50 percent of the gain to 30 percent."

As noted in his message, this proposal, along with his recommended reduction of the personal income tax rate schedule from a 20 to 91 percent range to a 14 to 65 percent range, would have produced capital gains rates on long term gains that would start at 4.2 percent and progress to a maximum of 19.5 percent instead of the then existing 10 to 25 percent range.

I should interpolate that at the time of the proposal made by President Kennedy, there were about 17 million stockholders. Their share

of ownership was heavily concentrated in the high income group and there had been a rise from 6.5 million in 1952 to 15 million shareholders in 1961 and 17 million in 1962.

The thrust of President Kennedy's recommendation was not to spread benefits around among taxpayers by this proposal, but to give a new dynamic to the economy which, at that time, was suffering under a lack of job creation and capital formation and investment, and many of the concerns of this committee today.

Today, as in 1963, as President Kennedy observed in his Tax Message supporting this recommendation: "The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy. The provisions for taxation of capital gains are in need of essential changes designed to facilitate the attainment of our economic objectives."

Unfortunately, and I believe unwisely, some of the changes in the revenue laws affecting capital gains in the 1969 Tax Act and subsequent acts have moved in the opposite direction to that recommended by President Kennedy. They have placed heavier rather than reduced tax burdens on capital gains. They have adversely affected the investment decisions of individual taxpayers in the directions he espoused.

These additional taxes on capital gains have tended to immobilize risk capital in static situations rather than increasing its mobility to more dynamic situations.

They have directed savings by individuals into consumption or relatively risk free debt instruments rather than into risk capital for new ventures or small- and medium-size businesses, with their vast potential for job creation, new products and services, increased competition, and growth of the taxpaying, revenue-producing private sector.

They have been conducive to a trend by major, well-established companies to use debt rather than equity investment for the financing of the expansion of business or the acquisition of new plant and equipment to increase productivity and capacity.

They have tended to reduce substantially the number of individual Americans who have direct ownership positions in private enterprise and, hence, a stake in the preservation of its dynamic role in our society.

These are not merely my conjectures.

They are supported by a wealth of evidentiary and statistical fact assembled and presented before subcommittees of this Committee in hearings several years ago chaired by Senator Bentsen and, more recently, on June 28 and 29 of this year before the Subcommittee on Taxation and Debt Management, chaired by Senator Harry Byrd.

Many Senators, most notably Senator Hansen of this committee, have hammered home these and related observations and organized sentiment to take remedial action for which I, for one, am grateful.

Both present law and the House bill leave unchanged the provision for the inclusion of 50 percent of long term capital gains taxable as personal income that President Kennedy would have reduced to 30 percent.

It is my conviction that an amendment incorporating his proposal is sorely needed along with other measures included in the House bill modifying the tax treatment of long-term capital gains.

It is needed as a clear and unequivocal signal to every taxpaying American from the lowest to the highest bracket that his National Government encourages him or her to save and invest in an ownership share in private productive enterprise.

Your chairman, Senator Long, has been zealous to reward the worker, to use his words in a recent notable address to the National Press Club, with "a piece of the action in the company for which he worked."

I would hope that in the legislation before this committee, the Senator, the Conference and the President, to use Senator Long's words again, will "help the rank and file of Americans to own a stake in our free enterprise system."

Now, by adding the proposal of President Kennedy to the House bill, the Congress will provide a system of capital gains taxation appropriate to the times and to a better functioning national economy. It is needed to provide a dynamic element in that economy, dependent as it is on private investment in the private sector for increasing growth, jobs, and productivity.

The alternatives are to do nothing more or to merely restore the alternative ceiling rate of 25 percent on long-term capital gains which was the law prior to the 1969 Tax Act.

To leave the top rate on long-term capital gains at 35 percent, as the House bill does, would not provide a meaningful reduction for taxpayers in the tax brackets from the bottom to the top of the income scale whose capital gains are not substantially affected by the minimum tax and the maximum tax. This would be true of the overwhelming majority of individual taxpayers. The House bill would fail to provide the incentive necessary to encourage taxpayers up and down the income scale to save and invest their savings as risk capital. It would retain the most retrogressive feature of the 1969 act, the provision that directly lifted the top rates on long-term capital gains from 25 percent to 35 percent.

To increase the reduction only by restoring the alternative tax provision that placed a ceiling of 25 percent on the taxation of long-term capital gains, which is one of the effects of the Steiger-Hansen bill, commendable as it is, would provide additional incentive to save and invest risk capital only for a relatively small minority of relatively high-income taxpayers who are in the income brackets above 50 percent. For example, married couples filing jointly with incomes of $53,000 or over.

The Kennedy proposal added to the House bill would provide more meaningful tax reduction on capital gains for all individual taxpayers regardless of their bracket with the tax range being from 4.2 percent to 21 percent.

Moreover, the Kennedy proposal does equity in the sense of taxing only 30 percent of the capital gain of any taxpayer, but maintains the relative progressivity in taxing capital gains as the tax rates on ordinary income.

In speaking of this aspect of the Kennedy proposal, Secretary of the Treasury Douglas Dillon, in testimony before the House Ways and Means Committee in 1963, said: "It will result in more equal treatment of individuals in various income groups. Unlike the present arrangement, the relative difference between capital gains tax

rates and ordinary income tax rates would be the same at all levels of income."

I have compiled a table, Mr. Chairman, that illustrates these points by comparing the taxation on the $5,000 caapital gain accruing to a married couple filing jointly without reference to the minimum-maximum tax provisions, under (a) existing law; (b) the House bills; (c) the restoration of the alternative tax fixing at 25-percent ceiling on the capital gains tax; and (d) the Kennedy proposal, reducing the inclusion of a long-term capital gain taxable as ordinary income from the present 50 percent to 30 percent.

Mr. Chairman, because I did my own work without any technical assistance, I find that my table is not adequate in one respect. I find that this table, which is on page 10, does not adequately reflect an additional tax burden that the House bill would place on capital gains. That bill eliminates the provision in the present law which allows individuals who have the first $50,000 of their long-term capital gains taxed at an alternative range not exceeding 25 percent.

To correct the table to reflect this feature of the House bill, it will be necessary to: (a) Put $1,250 in column 3 opposite the brackets in column 3 from 53 percent up and put 25 percent in column 4, opposite these high brackets; (b) add an additional column 8a under the House bill section b of the table. This column would be headed "tax increase" and insert the same figures contained in column 11.

Senator HANSEN. May I interrupt to ask you, Mr. Secretary, to repeat again how we need to change this table?

Mr. FOWLER. I am going to prepare a separate table and submit it for the record. I found this out in reading the report of the House bill and the debates and reading the measure myself, and I did not have time to do all of the detailed computations with my little yellow pad that would be necessary.

So if I may present later a substitute table.

[The following was subsequently supplied for the record:]

GOLDMAN SACHS & CO.,
New York, N.Y., August 24, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: You will recall that in my testimony last Tuesday, August 22nd, on the Tax Bill, I made the comment that the Table on page 10 of my statement did not reflect the House action in repealing the special 25 percent ceiling on taxes on capital gains up to the first $50,000. At that time I asked for permission to submit a revised Table which would reflect that change.

Enclosed please find a copy of the revised Table, which I would appreciate being placed in the Record.

Thanking you again for your courtesies in connection with my appearance before the Committee on this important matter, I am with best wishes,

Sincerely yours,

HENRY H. FOWLER.

TAXATION OF LONG-TERM CAPITAL GAINS UNDER VARIOUS ALTERNATIVES (WITHOUT REFERENCE TO MINIMUM AND MAXIMUM TAX PROVISIONS) ON A $5,000 CAPITAL GAIN [1] OF A MARRIED COUPLE FILING JOINTLY

	A. Existing law (not including minimum and maximum tax)			B. House bill					C. Addition of alternative 25 percent ceiling to House bill			D. Kennedy proposal for 30 percent inclusion				
Taxable income bracket (thousands)	Tax rate present law (percent)	Present tax on 50 percent inclusion	Percent of gain collected as tax	Tax rate in House bill (percent)	Tax on 50 percent inclusion	Percent of gain collected as tax	Savings over present law	Tax increase	Percent of gain collected as tax with 25 percent ceiling	Tax on 50 percent inclusion with 25 percent ceiling	Savings over House bill	Tax using House bill and Kennedy inclusion rate (30 percent)	Percent of gain collected as tax	Savings over present law	Savings over House bill	Savings over House bill and 25 Percent ceiling
	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(8a)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
$4,000	14	$350	7.0	14	$350	7.0	0	0	7.0	$350	0	$210	4.2	$140	$140	$140
$8,000	19	475	9.5	18	450	9.0	$25	0	9.0	450	0	270	5.4	205	180	180
$12,000	22	550	11.0	21	525	10.5	25	0	10.5	525	0	315	6.3	235	210	210
$16,000	25	625	12.5	21	525	10.5	100	0	10.5	525	0	315	6.3	310	210	210
$20,000	28	700	14.0	24	600	12.0	100	0	12.0	600	0	360	7.2	340	240	240
$24,000	32	800	16.0	28	700	14.0	100	0	14.0	700	0	420	8.4	380	280	280
$28,000	36	900	18.0	32	800	16.0	100	0	16.0	800	0	480	9.6	420	320	320
$32,000	39	975	19.5	36	900	18.0	75	0	18.0	900	0	540	10.8	435	360	360
$36,000	42	1,050	21.0	39	975	19.5	75	0	19.5	975	0	585	11.7	465	390	390
$40,000	45	1,125	22.5	42	1,050	21.0	75	0	21.0	1,050	0	630	12.6	495	420	420
$44,000	48	1,200	24.0	45	1,125	22.5	75	0	22.5	1,125	0	675	13.5	525	450	450
$52,000	50	1,250	25.0	50	1,250	25.0	0	0	25.0	1,250	0	750	15.0	500	500	500
$64,000	53	1,250	25.0	53	1,325	26.5	0	$75	25.0	1,250	$75	795	15.9	455	530	455
$76,000	55	1,250	25.0	55	1,375	27.5	0	125	25.0	1,250	125	825	16.5	425	550	425
$88,000	58	1,250	25.0	58	1,450	29.0	0	200	25.0	1,250	200	870	17.4	380	580	380
$100,000	60	1,250	25.0	60	1,500	30.0	0	250	25.0	1,250	250	900	18.0	350	600	350
$140,000	64	1,250	25.0	64	1,600	32.0	0	350	25.0	1,250	350	960	19.2	290	640	290
$180,000	68	1,250	25.0	68	1,700	34.0	0	450	25.0	1,250	450	1,020	20.4	230	680	230
$300,000	70	1,250	25.0	70	1,750	35.0	0	500	25.0	1,250	500	1,050	21.0	200	700	200
$400,000	70	1,250	25.0	70	1,750	35.0	0	500	25.0	1,250	500	1,050	21.0	200	700	200

[1] Since the present law applies a special 25 percent ceiling on taxes on capital gains under $50,000 for the taxable year, which provision would be repealed by the House bill, a similar table for a capital gain well above the $50,000 level would show increased percentages of gain collected as tax in col. 4 for the brackets above 50 percent and additional proportioned savings over present law in col. 14.

Mr. Fowler. What it would do—just to give you a quick impression of what one would do to correct the table to reflect that feature, you would put $1,250 in column three opposite all of the brackets from 53 percent up, and put 25 percent as a ceiling opposite those higher brackets, since the capital gain that we are treating in this table is a $5,000 capital gain and therefore affected by this change.

The second thing one would do would be to add an additional column, 8(a) under the House bill, section (b) of the table. This column would be headed "Tax Increase," and it would insert the same figures that are contained in column 11.

Column 11 should be retained as is to reflect the savings the restoration of the full alternative capital gains provision contained in the law prior to the 1969 act.

This proposal, if enacted without the addition of President Kennedy's proposal, would place a much heavier burden on the realization of capital gains in amounts less than $50,000 by taxpayers subject to a higher bracket whose marginal rate exceeded 50 percent. Instead of paying 25 percent on the first $50,000 of capital gains in any 1 year, the taxpayer would pay up to 35 percent.

At least look at the table—and I will not take you through it in detail. It is a very busy table, with lots of figures, but the essence of it, in the righthand side, under the Kennedy proposal for 30-percent inclusion, provides in column 12 what the tax would be in the various brackets on a $5,000 capital gain for the taxpayer within a given bracket.

Column 13 would give the percentage of that gain, which would be collected as a tax. Column 14 would give the savings in dollars over present law for each of the brackets.

Column 15 would give the savings in dollars over the House bill and column 16 would give the savings in dollars over the House bill and the 25 percent ceiling restoring it to pre-1969 levels.

Mr. Chairman, I do not wish to be misunderstood on several scores. The remainder of my statement concerns three points which I will not cover in detail, but simply mention here.

First, my advocacy here is limited to this question of capital gains taxation, but it should not be confused with an expression of a belief that the measures advanced in this area, standing alone, are a cure-all for our tax and fiscal problems or our broader economic ills. I would not wish to make exaggerated claims for a substantial reduction in capital gains tax.

After this bill is enacted, I am sure that much will lie ahead for future Congresses to do in adapting our tax system to changing times and in dealing with other measures, the problems of inflation, jobs, inadequate capital formation, low levels of productivity increase, imbalances in our international payments and internal budgets and the declining dollar in a matter consistent with our national security and national welfare.

The point is that in any mosaic of measures designed to treat these problems, the Nation needs as a central element a system for taxing capital gains that provides an incentive to save and invest risk capital in private enterprise.

The second observation I would make is what I am proposing here, the adoption of President Kennedy's formula, should be combined

with the modification of the minimum tax and a maximum tax provision which were added in the 1969 tax act and subsequent acts. Their present application to capital gains should be removed while substituting the so-called alternative minimum tax on those taxpayers who otherwise would avoid paying any appreciable income tax by combining capital gains with tax shelters.

Third, and last, I deal with the question of revenue effects because, in advancing President Kennedy's formula, I have given careful consideration to revenue effects, particularly to do with the fact that there is a large budget deficit which should be of concern to the Congress.

In conclusion, Mr. Chairman, my own personal conviction is, for the reasons stated in the intervening pages, that the increase in the number of taxable transactions involving long-term capital gains and the volumes of those realized gains, plus the more indirect or highly desirable economic consequences of a substantial reduction of capital gains taxes will more than compensate the Treasury for the reduced amount of tax paid per dollar of gains realized.

So, in concluding, let me thank you, Mr. Chairman and members of the committee, for permitting me to bring this nostalgic note from past history to bear upon a vital issue of the present.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. I am going to pass, Mr. Chairman, because other members may have questions.

The CHAIRMAN. Mr. Secretary, you say in effect in your statement that a lower tax rate on a dynamic economy would generate more revenue than a higher tax rate on a stagnant economy. That is basically what you are saying here.

Mr. FOWLER. Exactly.

If I may say so, that was the assumption used by the 1963 Treasury Department in estimating the revenue effects of the capital gains taxes that was recommended by President Kennedy, including the reduction of the inclusion rate from 50 percent to 30 percent. Indeed, the Treasury Department, speaking through Secretary Dillon, presented to the committee an estimate of revenue effects showing that what he called the induced effects of the package of changes of the taxation of individual capital gains would increase revenue by $690 million.

The CHAIRMAN. Is it not also true that excessively high taxes on risk capital and also excessively high taxes on our most enterprising people reduce Government revenue compared to a system to assure adequate incentives to take a risk and to expand business activity?

Mr. FOWLER. Yes, Senator Long. That phenomenon which is generally referred to as the lock-in effect of high rates on capital gains was one of the major considerations that caused President Kennedy and Secretary Dillon and me to advance this proposal. We felt—and, as Secretary Dillon said at the time, testifying before the House, that independent outside surveys, our own studies, letters and comments we received daily from taxpayers throughout the country, indicated clearly that these substantial reductions will increase taxpayers' willingness to realize capital gains and stimulate a larger turnover in capital assets which would, in turn, increase the revenue from capital gains taxation.

The CHAIRMAN. I was surprised some time ago to learn, in talking with a man I consider one of the brightest and ablest chief executive

officers in America, that he was not investing money in his company, but instead he was investing it in vacant real estate.

And, after I thought it through, if you look in terms of the risk you take and the tax brackets that such a person is in, it would not pay him to invest his money in his own company. In fact, I was analyzing what happens when you are in a 70-percent tax bracket and a corporation pays 46 percent. When you take risk into account, if the company were making a 50-percent profit before Federal taxes, not counting State taxes, by the time all the taxes were paid and the dividend got through to him, assuming the company declared dividends, he would make a little less than 8 percent.

It would be a better investment to put his money in a tax exempt State or local bond. He would take far less risk and the return would be almost as good—and probably an even better investment would be to put his money in vacant land, even if the stuff is very highly priced compared to yield now.

Mr. FOWLER. As one of the previous witnesses referred to, we have seen a great proliferation of new schemes and arrangements to preserve values and get some yield and this has caused a tremendous diversion in the flow of capital into these other arrangements rather than into the risk capital that is so necessary for the overall economy.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. My only comment is to echo, really, what is being said. When people try to equate all types of income they make a serious mistake because they do not take into account risk, and when they say people who are making over $50,000 receive a certain percentage of the benefits, they are going to take that capital away from those people, those people are simply going to put it in things that are safer. They are going into bonds, mortgages, and things that have an assured return, because they are not going to put it in a venture capital situation if they cannot keep a substantial amount to keep up with the correlated risks that you have.

Mr. FOWLER. Your experience Mr. Chairman, with that gentleman in question is so commonplace in the business, that we think that it is not an exception, but rather the ordinary attitude.

The CHAIRMAN. If you would stay, Mr. Fowler, we will vote and come right back.

[A brief recess was taken.]

Senator BYRD. The committee will come to order.

I might say that in the judgment of the Senator from Virginia it is a hell of a way to legislate when we have vitally important legislation before this committee and the Senate simultaneously has extremely important legislation before it, and trying to handle both at the same time does not appear to me to be in the best interests of the people of our Nation.

Mr. Secretary, we are so pleased to have you back before this committee.

Mr. FOWLER. Thank you, Senator.

Senator BYRD. I am very impressed with your statement. It is very persuasive. One reason I do is because of my extremely high regard for you. As I understand your thinking, at the very minimum this committee and the Congress should go back to the pre-1969 legislation insofar as capital gains treatment is concerned and then you would---

go a step, you might say, beyond that, and put a maximum rate of 15 percent.

Mr. FOWLER. A range from 4.2 percent of the people in the lowest bracket to 21 percent to the people in the highest barcket on capital gains.

Senator BYRD. Do you not have a 38-percent exclusion?

Mr. FOWLER. You would do that by reducing the inclusion of the capital gain that is taxable as ordinary income from 50 percent to 30 percent and the consequence of that would be to reduce the rate range, as indicated in column 13 of my table on page 10, from 4.2 percent up to 21 percent.

Senator BYRD. So 21 percent would be the maximum tax instead of the old maximum tax, as I recall, of 25 percent?

Mr. FOWLER. Right.

Senator BYRD. I have felt for some time that the Congress made a mistake in 1969 in changing the capital gains treatment. I must say I voted for it and I share that responsibility.

Mr. FOWLER. I thought so at the time, too, Senator, and attached as an exhibit to my testimony is a letter which I sent on August 28, 1969, which I pointed out at that time to President Kennedy's proposal and suggested that the bill was moving in the opposite direction and registered my own feelings at that time that it would be unwise to, in effect, increase the scale of taxation of capital gains from the 25-percent minimum to 35 percent.

Senator BYRD. You feel, as I understand it, that the House action, as evidenced by the bill that is before the committee now is inadequate, that 35-percent figure is too high. It is inadequate to accomplish the purpose for which it was intended?

Mr. FOWLER. Yes, sir.

Senator BYRD. Thank you.

Senator Nelson?

Senator NELSON. I do not have a chart that breaks down the distribution of the benefits of the Kennedy proposal. Do you have a chart that shows what income brackets receive what percent of the distribution of the tax benefits of that proposal?

Mr. FOWLER. No, sir, I do not. Since I have had no computers, no technical machinery and no access to a lot of the current information that would be available in the Treasury, and all I have been able to compile is this table which appears on page 10 which takes a particular case, a $5,000 capital gain for a married couple filing jointly and shows the savings in dollars over present law and over the House bill and what the percentage of taxation would be as compared to present law and as compared to the House bill.

What that adds up to in terms of spreading of the benefits of so-called tax reduction into the various brackets, I do not have—and let me say, my own point of view is that it is not terribly material because it is not the purpose of this proposal to spread benefits to people who have capital gains.

The purpose of it is to engender a far greater savings by people from their sources of income and the investment of those savings in producing activities.

And therefore, the objective, it seems to me—certainly it was the objective, as President Kennedy indicated, was not to give benefits

directly to the taxpayer but to encourage the taxpayer to use his savings and his income in risk capital.

Senator NELSON. You state on the bottom of page 7, top of page 6 of your testimony that one of the effects of the Steiger-Hansen bill, is that it would provide additional incentives to save and risk capital only for a small minority of high-income taxpayers who are in income brackets above 50 percent.

Mr. FOWLER. Yes, sir.

Senator NELSON. I take it part of your objective is to provide a tax structure that would induce a much broader spectrum of investors into the market?

Mr. FOWLER. Exactly.

Senator NELSON. Looking at the House bill—I do not have an analysis of the Kennedy proposal but in looking at the House bill and comparing it with a proposal I mentioned previously to exclude the first $1,500 of individual capital gains and the first $3,000 of a couple, I find that under this proposal 4,253,000 taxpayers in the market would benefit, whereas the House bill would benefit only 327,000 taxpayers.

Moreover, under this proposal, a substantial percentage of the benefits would be going to the small investors who represent a substantial percentage of the investors in the marketplace with holdings of $10,000 or less.

Mr. FOWLER. The only facts that I could add to what is here, I noted in the Congressional Record of the debate on the House bill that, according to Congressman Steiger—and this is on page 8281—he says that 50 percent of all of the returns claiming capital gains had incomes below $15,000 of adjusted gross income.

I do know that back in 1963 when this Kennedy proposal was made, that there were—and you will find them in the record of the House hearings of the 1964 tax bill—tables indicating the distribution of capital gains among the various income groups. For the record, at table 3 on page 380, document 43 of the 88th Congress, First Session, you will find a table indicating the participation of taxpayers in various adjusted gross income classes in long-term capital gains.

That table, I happen to have in front of me here, and it shows of the $12 billion—the heading is, "Amounts and Percentages of Long-Term Capital Gains Among Income Classes" and that of the $12 billion of then-existing capital gains, about $3.5 billion was held by taxpayers with adjusted gross income under $10,000.

An additional $4.3 billion was held by taxpayers with adjusted gross income of $10,000, up to $50,000; and then $1.5 billion of taxpayers from $50,000 to $100,000; and then nearly $2 billion of the $12 billion by taxpayers of $100,000 to $500,000; and then $983 million by taxpayers in the adjusted income brackets of $500,000 or more.

So at that time, Senator Nelson, those figures would indicate that there was a large amount of capital gains held by taxpayers in the adjusted gross income levels below $10,000 and an additional large amount, $4.5 billion roughly, in the adjusted gross income from $10,000 up to $50,000.

Senator NELSON. My time has expired.

The CHAIRMAN. Do you have any additional questions?

Senator NELSON. What I was simply getting at is that if you were trying to induce people to participate in the marketplace, which every-

body seems to think is a good idea, why would it not be better to give an exclusion to everybody of the first $1,500 for an individual and an exclusion of $3,000 for a couple?

Mr. FOWLER. I think that would certainly be quite effective in inducing the small investor who does not expect to realize very much on his investment. But it would not be effective in unlocking the major flows or converting unrealized capital gains into realized capital gains that exists, and would not accomplish the unlocking of the unrealized capital gains and the movement of risk capital from the more or less stable, stolid situations to the more dynamic situations.

So that it would do a part of what President Kennedy would seek to accomplish, namely to encourage people in the very low brackets by giving them a reduction as well as people in the high brackets, but I do not think it would be effective in unlocking the flows of the people who can undertake really major investments.

Senator NELSON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth?

Senator CURTIS. Would you yield for a unanimous-consent request?

Senator ROTH. Yes.

Senator CURTIS. Mr. Chairman, I have a statement here of Senator Paul Laxalt that he would like incorporated into our hearings today, following any other statements that the chairman remembers.

The CHAIRMAN. It will be done.

[The material referred to follows:]

STATEMENT ON BUSINESS MEALS

(By Senator Paul Laxalt)

Mr. Chairman, I am delighted that the House has chosen to reject the Administration's proposals to reduce expense account deductions for business meals. Business meals, including those involved in conventions, banquets and clubs, provide enormous opportunities for employment for people in my state and throughout the nation who are involved in serving and preparing the meal, to their suppliers and to many thousands of others in related industries. Indeed, it is fair to say that business meals provide employment throughout the entire food production chain, from farm to final consumption.

As the House hearings clearly demonstrated, the Administration's proposal to cut this deduction jeopardized some $8 billion in food service and lodging industry sales and $1.2 billion in revenues directly derived from expense account spending. Most important, this translates into some 70,000 jobs.

As you once said, Mr. Chairman, "entertainment is to business what fertilizer is to agriculture—without it nothing grows." Nowhere is this more true than in Nevada. The Reno-Sparks Convention Authority has figures indicating that Nevada leads the Mountain States in expense account sales with $175 million annually and that more than 11,000 people are employed in the Nevada food and beverage industry. Not only would a large percentage of these jobs be jeopardized by a cut in the business meals deductions, but the almost five and a half million dollars collected by the state in sales taxes on these expenditures would also be reduced. What is more, Mr. Chairman, although some might argue that business meals are little more than frivolity those of us who have been involved in the food service and lodging industry know better. When sales efforts in the convention business are extended into a luncheon or dinner appointment, it can hardly be considered a fringe benefit for it actually adds additional hours to the working day.

Also, at a time when the nationwide emphasis is on increased employment it is inconceivable to me that anyone would want to advocate this "reform" since it can only lead to thousands of lost jobs, particularly among the unskilled and minorities.

One Nevada firm, Fred Harvey Inc., illustrates my point both with respect to minorities and more generally. I would like to quote directly a letter their general manager addressed to me on this subject.

"Fred Harvey, Inc. employs approximately 4,000 individuals in its 41 operations. One-third of these employees are minorities. Any decrease in our business brought upon by changes in the present tax structure will adversely affect all employees, including these minority group employees, as decreased business leads to shorter work periods and smaller work staffs. We do not want this to happen!"

Mr. Chairman, I agree. I do not want to reduce the present provisions for deductibility of business meals. The House has chosen wisely to bury this so-called reform. And I note that even Secretary Blumenthal in his testimony last week chose not to resurrect it. I am sure this committee in its wisdom will let this dead dog lie.

The CHAIRMAN. Senator Roth?

Senator ROTH. Mr. Secretary, I appreciate very much your comments and I share much of the same concern expressed by you. I have long urged this administration, as a matter of fact, to follow the tax policies that President Kennedy set in motion and I think it is interesting in your letter to our chairman, worth repeating, you say, "Had some miracle been forged in the fires of war in Vietnam that has so altered our economic system as to solve permanently the problems diagnosed by President Kennedy as recently as 1963? Are the words that he uttered then already obsolete, not only for the years of war and its accompanying inflation, but for the years of peace ahead?"

And you quote, "The chief problem confronting the economy in 1963 is unrealized potential, slow growth, underinvestment, unused capacity, persistent unemployment; and the result is lagging wage, salary, and profit incomes, smaller take home, insufficient productivity gains, inadequate Federal risk and persistent budget deficit."

Is that very much like today, Mr. Secretary; would you agree?

Mr. FOWLER. Yes; I do. There are some elements that are present today that were not present then, but many of the same problems that existed that you were referring to exist today.

Senator ROTH. The then-President pointed out in his message to the Congress that there were two directions that this country could go. One was in the direction of continued increased spending. The second was to free up the private sector and give it the opportunity to show what it can do, and President Kennedy selected the latter.

One of the things in his message, he, of course, not only combined the capital gains—which I am a cosponsor and strongly support—but he also proposed that something be done with respect to the drag of personal income taxes by putting into effect, really, one of the largest tax cuts in the history of this country.

President Carter has said at one stage that we ought to reduce taxes on the high side by something like, I think, 50 percent; on the low side, 14 to 10 percent. And I, to, believe that we ought to try to set a pattern now to reduce this personal drag of taxes.

I wonder if you would care to comment on that?

Mr. FOWLER. Yes: I would like to say that I think that what you and Congressman Kemp and many others have done to revisit, so to speak, the tax policy philosophy of the Kennedy period is a very worthwhile and desirable course, and I, for one, want to commend you for it and say that I share very much the general philosophy that I think you have been advocating.

I also want to say that I think that many of the problems that you are addressing yourself to are the problems that President Kennedy indicated were the problems that he was addressing in the tax message of 1963.

I do want to point out that there are several factors, however, that exist today that did not exist at that time which are relevant to how one proceeds to implement the policy and point of view that you espoused and in which I concur.

That is, we do have a very serious problem with the dollar and the attitude toward the dollar and the outside world.

Second, we do have a very major problem of inflation which is really the No. 1 problem and, as you know, President Kennedy said at that time that his recommendations—I am quoting from the second page of his message—"Our recommendation for a revision of our tax structure is not motivated by any threat of imminent recession or should it be rejected by any fear of inflation or weakening of the dollar as a world currency."

So that I think in proceeding to implement your point of view, it is very important to take into account the related question of controlling the growth of expenditures and the related question of gearing into this adding dynamic to our system in such a way and at such a pace that we do not reinvigorate, or give more vigor, to an already very damaging inflation.

So, given the new budget procedures of the Congress and the new—shall we say relationship between this committee and the Senate Budget Committee and the Ways and Means Committee and the House Budget Committee, I would hope that, over time, that over a 3- or a 5-year cycle, whatever it might be, that we could gear into our present system the direction in which I think you are trying to go, but with great care and with great precision that is accompanied by a degree of expenditure control and concern about the psychological attitudes that inflation expectations might arise.

Senator ROTH. If the chairman would be indulgent, I would move forward a few more minutes, because I think this is a critical point.

Mr. Secretary, I share the concerns which you have just addressed, and I do believe that through the budget resolution or some other techniques that we should try to adopt, or realize the goal that in fact President Carter has discussed and many of us on the other side of the political fence have discussed, and that is to reduce the percentage of spending in relation to GNP.

I think President Carter has talked about reducing 22 to 21 percent. Other economists have talked about 23 percent. I think that, by one technique or another, we should try to impose some realistic goals and discipline in this system, and I intend to either work with others or to do that through the budgetary process when the second budgetary resolution comes up.

One of my concerns, however, is that spending is a very hard thing to get a hold of because the authorizations and the specifics always keep two jumps ahead of us, and for that reason I think a very long-term commitment right now on the revenue side is as important as many of the long-term commitments we have made on spending.

I think that the only way you are going to bring some discipline into the spending side is to make a long-term commitment to the American

people that we are going to allow them to keep a greater percentage of their earnings and revenue.

While one may argue the specifics of the Roth-Kemp—and I am not arguing them now—it does seem to me that there is great virtue in us today adopting legislation that would put us at the goal of 50 percent on the top side and 8 on the low. You may argue those figures a little bit but make it clear to the budget people that spending is going to have to be within that restraint—in other words, leapfrog for a chance the spending side.

This is a real benefit, because it gives a real signal of the type that Senator Kennedy was talking about, that this is not a temporary aberration. We really are going to free up the private sector to show what it can do and I think, as I say, I think this is, in essence, the best anti-inflationary measure that we have because we are laying the road, not only for the immediate future, but for several years down the road as to what direction we intend to go, and I wonder if you would care to comment?

Mr. FOWLER. Yes, sir. I think it is a very close question. It is a hen or egg problem of tax reduction and expenditure control.

If I could go to a personal note here, I learned my lessons on that particular question at the feet of Senator Byrd's father who was then chairman of the committee. Before the 1963 tax bill which was up at that time, was adopted, the administration had to come forward with a real, honest, good faith effort to commit itself to a degree of expenditure control before we could proceed with the business at hand, which was tax reduction.

And I know Senator Long was quite aware of all of this and all I would say is that I think that there needs to be—these two horses ought to be teamed up more together than apparently they are now, in order to proceed with the kind of program and policy that you advocate.

Whether or not commitment to a long-term program will have the psychological effect of inducing expenditure control or whether it will just take us down the road to, you know, increasing deficits, one does not tell, one does not know—I think the outside world and many of the people in the financial and business communities would be worried that until there is a much stronger demonstration by both the administration and the Congress of their willingness to put these two things together more or less into the same context that there will be some skepticism about proceeding directly down the road for a long-term commitment of the sort that you have in mind, without some grater assurance on the expenditure control aspect.

The CHAIRMAN. Senator, I will come back to you if you want to stay.

Senator Danforth?

Senator DANFORTH. Mr. Secretary, a followup on Senator Nelson's question and I will ask you sort of a philosophical question.

At this time, in the present economic conditions with this tax bill, how should we go about determining tax policy? Should we put greater emphasis on what you might call equity, or greater emphasis on what you might call economics?

Supposing capital gains were faced with two options: one would provide a little more relief for a whole lot of people and the other would provide more relief, but for fewer people; and supposing that

the first option provides very little economic bang for the buck and the second option provides quite a lot, which direction should we go?

Let us assume, just hypothetically, that there is a proposal that we provide tax relief only for people who have incomes that are up over $1 million and that all of our economic projections, all the econometric models showed, that the effect of doing that would be that these people would go out and do something which was manifestly socially desirable—that they would hire 100 people or that they would build a factory or they would put up a hospital or anything.

Should we reject that kind of proposal on the basis that it is tax relief for only a very few people?

Should we attempt to just offer a lot or a little bit for a lot of people?

It seems to me that if we had a tax system—I am told that something like 91 percent of the taxes are paid by people who are in the upper half of the earnings level, so that therefore it gets harder and harder to have a tax bill aimed at people in lower incomes.

So should we always do that? I mean, if we had a tax system in which no income taxes were paid by people who made below $50,000 a year, should we reject any tax cut because it only benefits people in the upper income brackets?

Do you get what I am talking about?

Mr. FOWLER. I do, and I think you have almost answered your question.

Senator DANFORTH. I have not answered it. I am only asking it.

Mr. FOWLER. I would say, looking at the problems of the times and the order of priorities as I see them, the problems of inflation, job creation, of the adequate capital formation of low levels of productivity, imbalances in our international payments, internal budgets, the declining dollar, the priorities should be given at this time to economic policy considerations and the economic consequences of what you do in tax policy.

That is not to say that tax equity has to always be a consideration. I think you will find in the tax act of 1964, despite some of the assumptions today that tax reform was just invented a few months ago or a few years ago, there is a very significant measure of tax reform in that tax reduction act of 1964 and there were in successive acts—in the act of 1962.

I could list quite a number of things that were generally considered by those who advocate tax equity as being advances achieved at that time.

So one, looking at a tax program, should always look at the economic consequences and to equity and simplicity.

But today, it seems to me that the first priority in the legislation before this committee ought to be in terms of economic consequences.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. No questions.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Mr. Secretary, I would like to compliment you on one of the best thought-out statements that I have read. I think it reflects the deep understanding you have of how our economy works. It reflects the clarity of comprehension that has always been the hallmark of your statements.

I want to take just a moment to comment on two things.

On page 5, you speak about some of the alarm bells that are going off. You note the drop in new public security issues for small firms from about 548 issues valued at $1.5 billion in 1969 to four new issues worth $16 million in 1975 with averages of $100 million per year in the 1972–77 period.

You also cite the falloff in the formation of new high-technology firms from 300 in 1968 to nearly zero in 1976.

After talking with some of the people in this country charged with insuring our national security, I am disturbed over the fact that new companies who are trying to put together the capital necessary to start on a new venture have been denied access to capital in this country, as borne out by the statement I have just read. Some of these companies have been forced to go abroad, specifically to Japan and to West Germany, and have been required to make major concessions to those two countries in marketing the highly technological inventions and creations that they produce in order to get the financing to start up in business.

Do you share my concern?

Mr. FOWLER. Very much.

I think the impact of the present situation and the consequences of the Tax Act of 1969 as it treated capital gains and the directions that we have been moving in since have had a very, very real impact in drying up sources of equity capital.

That is the lifeblood. It is what the new technology companies have to have. They cannot go to banks. They do not have large profits so they can expand and grow out of retained earnings. They really have to depend on what we call risk capital.

Whether a company like a Hewlett-Packard which was started in a small garage by Dave Packard and Bill Hewlett could develop today in the present environment with having anything like the speed and facility that it did in the period of the development, would be very doubtful in my mind.

People are turning to other ways of spending their time and their effort, and if they have capital, as Senator Long indicates, using it in other ways rather than in this type of dynamic development.

Senator HANSEN. Would you agree so that historically there has been a close connection between our technological superiority in this country and the power that we have been able to demonstrate internationally in trying to expand freedoms for people everywhere?

Mr. FOWLER. Yes, sir. The technological leadership of the United States—as one travels around the world, as one has to in my business, one finds that it is now somewhat in question as to, certainly in the civilian items.

I am not close enough to the situation to know what is happening on the military side.

Senator HANSEN. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, when you were in the Treasury as Undersecretary, President John Kennedy went before the New York Economic Club outlining the tax proposals that you are discussing here. His program included a drastic reduction in rates—the top rate to be cut from 92 percent down to 65 percent; a 7 percent investment tax credit; and rates reduced all the way down the line including this recommendation on capital gains.

He said if the Congress would pass this program, we will generate more revenues and, in the long run, have a balanced budget.

Since that time, we repealed the investment tax credit, and instead of making money we lost money, for the simple reason that it helped put the country in a recession by doing the kinds of things they told us not to do after you left the Treasury.

I would just ask you, do you think you would have been able to achieve that balanced budget if the Vietnam War had not heated up on you?

Mr. FOWLER. Oh, yes, we were headed right to it. There is not a doubt in my mind that we would have had a balanced budget. As a matter of fact, the deficit came down in fiscal 1965 and I believe even in fiscal 1966, although I would have to have my books and records here to be entirely accurate.

After the passage of the Tax Reduction Act of 1964 there was a decline in the deficit, a sharp decline in the deficit, and just as we were about to reach that hallowed era of a balanced budget, Vietnam expenditures began to creep in.

And then we only had a balanced budget—we had a small surplus, as you remember, in fiscal year 1968, which began on July 1, 1968, and extended to July 1, 1969. That was the only balanced budget we had during that period.

The CHAIRMAN. Did you, and the administration in which you participated, you advocate what amounted to major tax reductions, with the result that they bought more revenue to the Government because they improved the economy and caused the economy to move? It kept moving steadily out from the day you made those recommendations forward, did it not?

Mr. FOWLER. That is correct.

The CHAIRMAN. It kept going up as long as you were there?

Mr. FOWLER. Yes. I would have to agree with you, Senator.

The CHAIRMAN. Well, Mr. Secretary, let me just say that I would advise this administration, and I have spoken with everybody including the President on that, that we ought to get you in there and get your thoughts, because we have benefited from them here.

I am prejudiced, but in my judgment, you are the best Secretary of the Treasury the country has ever had. There may be one who is better. I do not know one who was, or had the opportunity to see what he had to offer.

But I think you did a great job for your country and we appreciate very much your appearance here today. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

I have been pretty well persuaded by your testimony today and by discussions with others, for that matter, that what the House did in regard to capital gains treatment, is totally inadequate, and that is your judgment, as I understand it?

Mr. FOWLER. That is my position. They corrected the unfortunate impact of the so-called minimum tax and the maximum tax but did not change the actual rates that go up to 35 percent.

Senator BYRD. There is not too much difference between your proposal and Senator Hansen's proposal, is there? The rates would go down a little bit more under your proposal than they would under Senator Hansen's proposal?

Mr. FOWLER. The difference is most notable, Senator Byrd, if you will look at the table on page 10 under section (c). What the addition of the 25-percent ceiling to the House bill would do would not provide any savings, any additional savings over the House bill to the people in the lower income brackets.

Do you see that line of zeros under column 11 there, all the way down? You would not begin to get any savings over the House bill, which I think is inadequate, until you get up above the 50-percent bracket, and then if you will look over in column 16, you will see that the Kennedy formula would provide meaningful savings for the people in the low-income brackets, so to speak, from $4,000 taxable income up to $52,000. That is the big difference between the two.

Senator BYRD. Thank you.

Just one further question. Assuming that this committee were to approve either the Hansen proposal or your proposal, what would be your judgment as to when the effective date should be?

Mr. FOWLER. My judgment would be that it ought to be effective as of the time when hopefully there is a Presidential signature.

Senator BYRD. Rather than wait until January 1, 1979?

Mr. FOWLER. Yes. I would defer to those who have much more acute market senses than I do, from whom you could get technical advice on this, but I believe that the technical advice you would get would be that there would be a very real concern, there would be something in the nature of a seizure in the market, in which they would, in effect, almost stop functioning except for those people who were not concerned about capital gains in the interim between passage of the bill and when it becomes law and the effective date.

I think it would be a market-disruptive factor.

Senator BYRD. Thank you.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. That would not be unusual for us to have taken that kind of action. We did it on the investment tax credit before, did we not? Otherwise, people would have withheld on buying new equipment, waiting until the new year if that would be the effective date. I would be very much in accord with having it take effect some time this year.

I have no further questions.

The CHAIRMAN. Senator Roth?

Senator ROTH. Mr. Secretary, I do not want to prolong the discussion, but I would just make the further comment that I agree with you as to the need of restraint on the expenditure side. It is my view that the best opportunity to impose some discipline and some restraint is along the lines that I suggest of making a structural commitment on the revenue side as we have done in the past on spending.

The only other comment that I would like to make is that I, too, hope that your voice could be listened to in the inner councils of this administration, because what concerns me the most is that it seems to me their proposals tend to be inflationary. They are more concerned with equity than economics and proposals of tax reduction by limiting them to the lower side of the economic scale will not provide the incentive to work or to save that I think that this country needs to have if it is going to work its way out, which I think President Kennedy tried to do.

Mr. FOWLER. Thank you, Senator.

Senator ROTH. I appreciate your being here today very much.

Mr. FOWLER. Thank you, Senator.

Senator MOYNIHAN. May I make a remark?

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. I would like to say what must be evident from the other comments. This has been superb testimony, Mr. Secretary, and we are very much helped by you. I would just like to repeat an observation I was making which I did not expect anybody to hear. That is, I do think that the questions of capital formation and technology innovation are central to this economy. Nothing would be more wonderful than to find out that it really has been a slight defect in our tax schedules that has brought about our present situation.

I am worried that it is probably not. The falloff from high technology firms since 1968 from 300 to zero is astonishing. But I cannot find myself convinced that it is altogether tax schedules that are the cause of this. If it turns out to be so, wonderful. If not, then there are other things to be pursued. They will get more and more elusive and more and more difficult, but they nonetheless will have to be pursued. I hope that we will followup from our predictions, as it were, from a very rational response. If we do not get a satisfactory result, we must think of what is next.

I am not asking you to say yes or no.

Mr. FOWLER. I tried to anticipate that. In my comments on page 11, I said although my advocacy here is limited to this one single question, it should not be confused as an expression of belief that this measure standing alone is a cure-all. The point I simply wanted to make was that in any mix or mosaic of measures that are designed to deal with the problem such as technology and its development that as an essential element, a system of taxing capital gains, that provides an incentive is an important part of that system, but not a total answer, in any sense of the word.

Senator MOYNIHAN. Well, sir, if you will excuse me, we do not look very polite here, do we. Apparently, I am Chairman.

Mr. Secretary, you have been magnificent. I have 3 minutes to vote, and we are told that we have recessed, but we will be back.

[The prepared statement of Mr. Fowler follows:]

STATEMENT OF HENRY H. FOWLER

My name is Henry H. Fowler.

I am a General Partner in Goldman, Sachs & Co., an investment banking and securities brokerage firm at 55 Broad Street, New York City. I appear here speaking for myself and not as a representative of any organization.

May I express my appreciation for the opportunity to present a statement to this Committee during its consideration of the pending tax bill.

By way of background for the newer members of the Committee, the record should show that I served as Undersecretary of the Treasury from January 1961 to May 1964, by appointment of President Kennedy and as Secretary from April 1, 1965 to December 20, 1968, by appointment of President Johnson.

My service as the Undersecretary and general deputy to Treasury Secretary Douglas Dillon included a very major involvement in working within the Treasury and the Administration and with the Congress and its Committees on the formulation and enactment of the tax programs of the early sixties. These included President Kennedy's Tax Messages of April 1961 and January 1963 and the enactment by Congress of the Revenue Act of 1962 and the Tax Reduction Act of 1964.

You will recall that, in addition to many detailed changes in the tax code that are generally regarded as "tax reforms", these measures included the initial

passage of the investment tax credit and the largest reduction in history of the rates of taxation on personal and corporate income taxes.

Despite the successful enactment, with some minor modification, of President Kennedy's recommendation for reduction in personal and corporate income tax rates, we failed to secure the passage of one of his key recommendations for a substantial reduction in the taxation of capital gains. That brings me to the thrust of my statement which deals with that piece of "unfinished business."

My views as a private citizen on the subject to be discussed are parallel to the views I expressed and espoused as Undersecretary and Secretary of the Treasury. A review of my public statements during tha period will attest to that fact.

Nor is my conviction that the increase in taxation of long term capital gains in the 1969 Tax Act was a mistake a recent or belated one. On August 28, 1969, I sent a letter to the Senate Finance Committee during its hearings on the bill that became the 1969 Act, opposing the increase in the rate of capital gains taxation by removing the maximum or alternative rate. I attach a copy of that letter as an exhibit to this statement. (See Exhibit I.) Its reasoning is in full accord with this statement.

The main purpose of this statement is to urge that the Congress, in its attempt to rectify the proven damage done to our system of capital gains taxation in the Tax Act of 1969, amend the House bill to include the adoption of the proposal for the reduction in taxation of long term capital gains, advanced by President John F. Kennedy in his Tax Message of January 24, 1963, which was not adopted.

He recommended that, in addition to enacting major reductions in the rates of taxation on personal and corporate income, the Congress should:

"Reduce the percentage of long term capital gains included in individual income subject to tax from the present 50 percent of the gain to 30 per cent." (See H.R. Document No. 43, 88th Congress 1st Sess. p. 23.)

As he noted in his Message, this proposal along with his recommended reduction of the personal income tax rate schedule from a 20 to 91 percent range to a 14 to 65 percent range, would have produced capital gains rates on long term gains that would start at 4.2 percent and progress to a maximum of 19.5 percent instead of the then existing 10 to 25 percent range.

Today, as in 1963, as President Kennedy observed in his Tax Message supporting this recommendation:

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy. The provisions for taxation of capital gains are in need of essential changes designed to facilitate the attainment of our economic objectives."

Unfortunately, and I believe unwisely, some of the changes in the revenue laws affecting capital gains in the 1969 Tax Act and subsequent acts have moved in the opposite direction to that recommended by President Kennedy. They have placed heavier rather than reduced tax burdens on capital gains. They have adversely affected the investment decisions of individual taxpayers in the directions he espoused.

These additional taxes on capital gains have tended to immobilize risk capital in static situations rather than increasing its mobility to more dynamic situations.

They have directed savings by individuals into consumption or relatively risk free debt instruments rather than into risk capital for new ventures or small and medium size businesses, with their vast potential for job creation, new products and services, increased competition, and growth of the tax paying revenue producing private sector.

They have been conducive to a trend by major, well established companies to use debt rather than equity investment for the financing of the expansion of business or the acquisition of new plant and equipment to increase productivity and capacity.

They have tended to reduce substantially the number of individual Americans who have direct ownership positions in private enterprise and, hence, a stake in the preservation of its dynamic role in our society.

These are not merely my conjectures.

They are supported by a wealth of evidentiary and statistical fact assembled and presented before subcommittees of this Committee in Hearings several years ago chaired by Senator Bentsen and, more recently, on June 28 and 29 of this year before the Subcommittee on Taxation and Debt Management, chaired by Senator Harry Byrd.

Many Senators, most notably Senator Hansen of this Committee, have hammered these and related observations and organized sentiment to take remedial action for which I, for one, am grateful.

Both present law and the House bill leave unchanged the provision for the inclusion of 50 percent of long term capital gains taxable as personal income that President Kennedy would have reduced to 30 percent.

It is my conviction that an amendment incorporating his proposal is sorely needed along with other measures included in the House bill modifying the tax treatment of long term capital gains.

It is needed as a clear and unequivocal signal to every taxpaying American from the lowest to the highest bracket that his national government encourages him or her to save and invest in an ownership share in private productive enterprise.

Your Chairman, Senator Long, has been zealous to reward the worker, to use his words in a recent notable address to the National Press Club, with "a piece of the action in the company for which he worked".

I would hope that in the legislation before this Committee, the Senate, the Conference and the President, to use Senator Long's words again, will "help the rank and file of Americans to own a stake in our free enterprise system."

Now, the heart of my statement.

By adding the proposal of President Kennedy to the House bill the Congress will provide a system of capital gains taxation appropriate to the times and to a better functioning national economy. It is needed to provide a dynamic element in that economy, dependent as it is on private investment in the private sector for increasing growth, jobs and productivity.

The alternatives are to do nothing more or to merely restore the alternative ceiling rate of 25 percent on long term capital gains which was the law prior to the 1969 Tax Act.

To leave the top rate on long term capital gains at 35 percent, as the House bill does, would not provide a meaningful reduction for taxpayers in the tax brackets from the bottom to the top of the income scale whose capital gains are not substantially affected by the minimum tax and the maximum tax. This would be true of the overwhelming majority of individual taxpayers. The House bill would fail to provide the incentive necessary to encourage taxpayers up and down the income scale to save and invest their savings as risk capital. It would retain the most retrogressive feature of the 1969 Act, the provision that directly lifted the top rates on long term capital gains from 25 percent to 35 percent.

To increase the reduction only by restoring the alternative tax provision that placed a ceiling of 25 percent on the taxation of long term capital gains, which is one of the effects of the Steiger-Hansen bill (S. 3065), commendable as it is, would provide additional incentive to save and invest risk capital only for a relatively small minority of relatively high income taxpayers who are in the income brackets above 50 percent. (For example, married couples filing jointly with incomes of $53,000 or over.)

The Kennedy proposal added to the House bill would provide more meaningful tax reduction on capital gains for all individual taxpayers regardless of their bracket with the tax range being from 4.2 percent to 21 percent.

Moreover, the Kennedy proposal does equity in the sense of taxing only 30 percent of the capital gain of any taxpayer, but maintains the relative progressivity in taxing capital gains as the tax rates on ordinary income.

In speaking of this aspect of the Kennedy proposal, Secretary of the Treasury Douglas Dillon, in testimony before the House Ways and Means Committee in 1963, said:

"It will result in more equal treatment of individuals in various income groups. Unlike the present arrangement, the relative difference between capital gains tax rates and ordinary income tax rates would be the same at all levels of income." (See H.R. Document 43, 88th Cong. 1st Sess. page 53.)

The following table illustrates these points by comparing the taxation on a $5,000 capital gain accruing to a married couple filing jointly, without reference to the minimum and maximum tax provisions, under:

A. Existing law;

B. The House bill;

C. The restoration of the alternative tax fixing a 25 percent ceiling on the capital gains tax;

D. The Kennedy proposal reducing the inclusion of the long term capital gain taxable as ordinary income from the present 50 percent to 30 percent.

TAXATION OF LONG-TERM CAPITAL GAINS UNDER VARIOUS ALTERNATIVES (WITHOUT REFERENCE TO MINIMUM AND MAXIMUM TAX PROVISIONS) ON A $5,000 CAPITAL GAIN [1] OF A MARRIED COUPLE FILING JOINTLY

	A. Existing law (not including minimum and maximum tax)			B. House bill				C. Addition of alternative 25 percent ceiling to House bill			D. Kennedy proposal for 30 percent inclusion				
Taxable income bracket (thousands)	Tax rate present law (percent)	Present tax on 50 percent inclusion	Percent of gain collected as tax	Tax rate in House bill (percent)	Tax on 50 percent inclusion	Percent of gain collected as tax	Savings over present law	Percent of gain collected as tax with 25 percent ceiling	Tax on 50 percent inclusion with 25 percent ceiling	Savings over House bill	Tax using House bill and Kennedy inclusion rate (30 percent)	Percent of gain collected as tax	Savings over present law	Savings over House bill	Savings over House bill and 25 percent ceiling
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
$4,000	14	$350	7.0	14	$350	7.0	0	7.0	$350	0	$210	4.2	$140	$140	$140
$8,000	19	475	9.5	18	450	9.0	$25	9.0	450	0	270	5.4	205	180	180
$12,000	22	550	11.0	21	525	10.5	25	10.5	525	0	315	6.3	235	210	210
$16,000	25	625	12.5	21	525	10.5	100	10.5	525	0	315	6.3	310	210	210
$20,000	28	700	14.0	24	600	12.0	100	12.0	600	0	360	7.2	340	240	240
$24,000	32	800	16.0	28	700	14.0	100	14.0	700	0	420	8.4	380	280	280
$28,000	36	900	18.0	32	800	16.0	100	16.0	800	0	480	9.6	420	320	320
$32,000	39	975	19.5	36	900	18.0	75	18.0	900	0	540	10.8	435	360	360
$36,000	42	1,050	21.0	39	975	19.5	75	19.5	975	0	585	11.7	465	390	390
$40,000	45	1,125	22.5	42	1,050	21.0	75	21.0	1,050	0	630	12.6	495	420	420
$44,000	48	1,200	24.0	45	1,125	22.5	75	22.5	1,125	0	675	13.5	525	450	450
$52,000	50	1,250	25.0	50	1,250	25.0	0	25.0	1,250	0	750	15.0	500	500	500
$64,000	53	1,325	26.5	53	1,325	26.5	0	25.0	1,250	$75	795	15.9	530	530	455
$76,000	55	1,375	27.5	55	1,375	27.5	0	25.0	1,250	125	825	16.5	550	550	425
$88,000	58	1,450	29.0	58	1,450	29.0	0	25.0	1,250	200	870	17.4	580	580	380
$100,000	60	1,500	30.0	60	1,500	30.0	0	25.0	1,250	250	900	18.0	600	600	350
$140,000	64	1,600	32.0	64	1,600	32.0	0	25.0	1,250	350	960	19.2	640	640	290
$180,000	68	1,700	34.0	68	1,700	34.0	0	25.0	1,250	450	1,020	20.4	680	680	230
$300,000	70	1,750	35.0	70	1,750	35.0	0	25.0	1,250	500	1,050	21.0	700	700	200
$400,000	70	1,750	35.0	70	1,750	35.0	0	25.0	1,250	500	1,050	21.0	700	700	200

[1] Since the present law applies a special 25 percent ceiling on taxes on capital gains under $50,000 for the taxable year, which provision would be repealed by the House bill, a similar table for a capital gain well above the $50,000 level would show increased percentages of gain collected as tax in col. 4 for the brackets above 50 percent and additional proportioned savings over present law in col. 14.

I would not wish to be misunderstood on several scores.

First, my advocacy here, limited to the field of capital gains taxation, should not be confused as an expression of belief that the measures advanced, standing alone, are a cure-all for our tax and fiscal problems or our broader economic ills. I, for one, would not wish to make exaggerated claims for a substantial reduction in capital gains taxes.

Other features of the House bill, for example, those dealing with the investment tax credit and the reduction in personal and corporate income tax rates are commendable. But, to play them off against a reduction in capital gains taxes for revenue consideration is to miss a vital point I will come to later. The nation needs those measures and a meaningful capital gains tax reduction as well to help overcome the investment lethargy that has overtaken it.

After this bill is enacted, much will lie ahead for future Congresses to do in adapting our tax system to changing times and in dealing with the problems of inflation, jobs, inadequate capital formation, low levels of productivity increase, imbalances in our international payments and internal budgets, and the declining dollar, in a manner consistent with our natioal security and national welfare.

The point is that in any mosaic of measures designed to treat these problems the nation needs, as an essential element, a system for taxing capital gains that provides an incentive to save and invest risk capital in private enterprise.

Second, you will note that my specific proposal is in addition to and not a substitute for other provisions of the House bill affecting capital gains, such as, for example, the one exempting the one time tax-free sale of a residence where the capital gain does not exceed $100,000. More specifically, the adoption of President Kennedy's formula should be combined with the modification of the minimum tax and the maximum tax provision, which were added in the 1969 Tax Act and subsequent acts. Their present application to capital gains should be removed while substituting the so-called alternative minimum tax on those taxpayers who otherwise would avoid paying any appreciable income tax by combining capital gains with tax shelters.

Also in the present highly inflationary climate these changes should be supplemented by a provision tempering the taxation of capital gains on such assets as securities, real estate, and plant and equipment held for long periods when increased values reflect inflation rather than increases in real realizable values.

This combination of measures, together with the existing provisions in the 1976 Revenue Act for "carryover" of basis for taxation to heirs at time of transfer at death, would provide the kind of tax system of capital gains envisaged by President Kennedy's 1963 program. It would couple the "liberalization of treatment with more sensible and equitable limitations" that he sought.

Third, in advancing the addition of President Kennedy's formula as an amendment to the House bill, I have given careful consideration to the revenue effects, particularly in view of the large budget deficit which is and should be a matter of deep concern to the Congress.

Since only 30 percent of long term gains would be subject to taxation under the proposed amendment, instead of 50 percent, some seem to assume that there would be an equivalent decline in revenues.

It is true that the amendment would reduce the amount of tax paid per dollar of capital gains realized.

But that method of calculation of revenue effect assumes that the same number of transactions involving the same amount of capital gains would occur with the law providing for 30 percent inclusion as with the present 50 percent inclusion.

That was not the assumption used by the 1963 Treasury Department in estimating the revenue effects of the capital gains package recommended by President Kennedy. Indeed, the Treasury Department then, speaking through Secretary Douglas Dillon, presented to the Committee a tabular estimate of revenue effects showing that the "induced effects" of the package of changes in the taxation of individual capital gains would increase revenue by $690 million, substantially exceeding estimated revenue losses from the proposed changes. (See table 11 attached to the Statement of Secretary Dillon, H.R. Document No. 43, 88th Cong. 1st Sess. p. 71.) A copy of that table is attached as exhibit II.

As Secretary Dillon explained in his statement to the House Ways and Means Committee in 1963, a substantial increase in revenue "will be realized as a consequence of the unlocking effects of the proposals and the greater volume of capital transactions that can be confidently anticipated." (See H.R. Document No. 43, 88th Cong., 1st Sess., p. 59.)

Somewhat earlier in discussing specifically the recommendation for the reduction in the inclusion as taxable income from 50 percent to 30 percent, the Secretary noted that:

"Independent outside surveys, our own studies, and letters and comments which are received daily from taxpayers throughout the country indicate clearly that these substantial reductions will increase taxpayers' willingness to realize capital gains and stimulate a larger turnover in capital assets." (See Document No. 43, p. 53.)

I share the view of the old Treasury and Secretary Dillon, particularly since, as noted before, the Congress has enacted in the 1976 law a provision for carryover of a decedent's basis at death, with the consequence that hereafter the capital gains tax on before death appreciation that acrues after the year of 1976 law will be paid when the property is sold by the heir.

The "lock-in" of unrealized capital gains will be diminished substantially by meaningful reductions in taxes on capital gains just as they were increased by their increased taxation in the Tax Act of 1969, as the able study of Professors Feldstein and Siemrod of the National Bureau of Economic Research entitled "The Lock-in Effect of the Capital Gains Tax" has persuasively demonstrated.

I do not present any precise estimate of the revenue effect of the addition of the suggested amendment. But I believe in the concept of "induced effects"—that the conduct of individual taxpayers will change with regard to saving, investment in risk capital, and the realization of capital gains, as the taxation of capital gains are increased or diminished.

Moreover, there will be more indirect economic consequences of an increased flow of risk capital into the economy, which, in turn, will produce additional taxable personal and corporate income yielding additional revenue that would not exist if the capital gains taxes were not reduced. These favorable economic consequences in terms of additional jobs and growth in the private sector with additional revenue to the Treasury are the subject of several scholarly detailed economic and statistical analyses already available to the Committee or forthcoming from later witnesses.

Rather than duplicate this testimony and information let me state a conclusion based on experience and judgment.

That conclusion is that the increase in the number of taxable transactions involving long term capital gains and the volume of those realized gains plus the more indirect but highly desirable economic consequences of a substantial reduction in capital gains taxes referred to above will more than compensate the Treasury for the reduced amount of tax paid per dollar of gains realized.

In so concluding, let me thank the Chairman and members of the Committee for permitting me to bring a nostalgic note from past history to bear upon a vital issue of the present. I hope it will be of some value to you in your important deliberations.

EXHIBIT I

NEW YORK, N.Y., *August 28, 1969.*

Hon. RUSSELL LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: I am submitting this letter as a Statement for inclusion in the record of the deliberations of the Senate Finance Committee on the proposed Tax Reform Act of 1969.

You and your colleagues have the highly important responsibility of reviewing and revising this bill as it passed the House of Representatives and working out any differences in Conference.

I have assessed my own responsibilities to comment as a private citizen (now a General Partner in the investment banking firm of Goldman, Sachs & Co.) and as the Under Secretary and Secretary of the Treasury from early 1961 through December 20th, 1968.

This letter is the result. My views as a private citizen on the subjects to be discussed are parallel to the views on these subjects I expressed as Under Secretary and Secretary of the Treasury as a review of my public statements during that period will attest.

There are a large number of provisions in the bill. Many of them reflect in whole or in part the Tax Reform Studies and Proposals of the U.S. Treasury Department, prepared during my tenure as Secretary by the Treasury Tax Policy Staff under the direction of Assistant Secretary Stanley Surrey, and published earlier this year (February 5th) for information only as a Joint

Publication of the House Ways and Means Committee and the Senate Finance Committee. Other provisions have been added on the recommendation of the new Administration or on the initiative of the House Ways and Means Committee.

On all save three specific provisions I shall follow the course I did in the House proceedings; namely, refrain from comment, technical and otherwise, preferring to stand on my general Statement on the Tax Reform Program of the Treasury Department, dated December 11th, 1968, which appears in full on pages 3 through 9 of Part 1 of the published report referred to.

But I do feel impelled to speak out on three specific provisions of the proposed bill which:

(a) were not included as needed reforms in the old Treasury report referred to and

(b) taken together, would reverse and undo salient features of a tax policy of vital importance to a viable economic system based on free private enterprise which tax policy was confirmed in the early sixties by the Congress on the recommendations of President Kennedy and President Johnson.

That policy, developed by the Treasury Department of those years in association with other parts of the Executive and Congress, was designed to safeguard and promote adequate private investment—as an essential ingredient in sustaining economic growth, increasing job opportunities in private enterprise in sufficient number and ever improving quality, providing a steadily rising standard of living, and keeping the U.S. economy competitive.

The three provisions referred to should be deleted because they are incompatible with the maintenance of a dynamic private sector in a free enterprise economy so long as the present and projected high tax rates on individual and corporate income persist. Moreover, they undo recently won advances toward a tax policy geared to sustained and non-inflationary economic growth and reasonably full employment in the private sector.

They would reverse a national policy as old as the nation and the federal tax system and as recent as the last major revision of our permanent tax structure in the 1960s—the placing of a high tax premium on the risk investment of savings or borrowed capital.

I refer to the provisions of the proposed bill which would (a) repeal the investment tax credit, (b) increase the rate of capital gains taxation by removing the maximum or alternative rate and (c) extend the period in which any investment must be held to qualify profits or losses therefrom as capital gains or losses.

In most of the advanced industrial countries in the Free World capital gains are not taxed. In these countries investment tax credits and special allowances are established features of their tax systems. They are considered fundamental to the national pursuit of non-inflationary growth and progress via increased production and productivity.

These policies, contrary to the proposed changes above, are supported in economies far more mixed than our own and far less dependent on private enterprise and investment. It would be ironic to downgrade or give a low order of priority to policies specifically designed to preserve the role of free private enterprise in a nation that has hitherto been an example of the success of that system.

Past Congresses have sought by these very features of the tax law now under attack to make our tax system compatible with a high rate of private investment. They should be preserved as long as that system is characterized by high tax rates on individual and corporate income.

The underlying policy common to these provisions under attack is simple—to maintain the vitality of a free private enterprise system dependent on large and continuing outlays of private capital.

Our national concern with the economy and the tax system—except in periods of war—and as recently as the early sixties—has been the inadequacy of the tax system in preserving the opportunity and incentive for private investment.

A rereading of the Tax and Economic Messages of the late President Kennedy in 1961–3 would raise serious doubts concerning the wisdom of tax proposals admittedly designed to diminish the premium and pace of risk investment.

A primary thrust of these Messages, confirmed as national policy in the Revenue Acts of 1962 and 1964, was the promotion of adequate private investment—the freer and fuller flow of capital into productive effort.

In his last Tax Message of January 24th, 1963, President Kennedy provided the policy basis for the Tax Reduction Act of 1964 in these words:

"Despite the improvements resulting from last year's depreciation reform and investment credit—which I pledged two years ago would be only a first step—our tax system still siphons out of the private economy too large a share of personal and business purchasing power and reduces the incentive for risk, investment and effort—thereby aborting our recoveries and stifling our national growth rate."

It seems unlikely that developments in the last few years of war, inflation, and rapidly expanding public expenditures have changed the truth and relevance of these words in his accompanying Economic Message of 1963:

"To raise the nation's capacity to produce—to expand the quantity, quality and variety of our output—we must not merely replace but continually expand, improve, modernize and rebuild our productive capital. That is, we must invest, and we must grow."

The meaning of these words is clear and unequivocal.

The nation does not need less capital and less private risk investment—it needs more.

It needs more private risk investment to provide more and better jobs which, in turn, increase total production and productivity, new products and services.

It needs more private risk investment to provide opportunities for all our citizens and to increase the standard of living for all.

What is the applicability of President Kennedy's pronouncement to the three provisions of the present bill?

Simply, that it would be a serious mistake to change our tax laws so as to discourage individual savers and corporations from investing for profit in private enterprise. By putting their savings and capital to work through risk investment, these individuals and corporations make our system a viable one.

We should never, in logic or by inference, subscribe to the proposition that a substantial tax premium for risking hard earned savings or borrowed capital in useful enterprise is a tax loophole or inequity.

This discussion is not addressed to policies that were formulated decades ago and have outlived their usefulness.

In 1962 Congress solemnly adopted as a permanent structural change in our economic and tax system a principle that was the investment tax credit. It provided that all those who invested earnings, borrowed money or equity capital in new machinery and equipment for business use should receive an investment tax credit for a percentage of that investment.

A vast majority of the members of the U.S. Senate voted for that proposal in late 1962.

Were they wrong?

They did not think so in 1964 when they voted to strengthen and improve the original provision.

They did not think so in 1967 when another overwhelming majority voted to restore the investment credit which had been temporarily suspended to cool down an excessive capital goods boom.

Why did these Sentaors, most of whom are still members of the body, vote for the investment tax credit?

It was designed, adopted and has proven effective:

For encouraging the development of new and better quality job opportunities, new products, new services, and new processes for improving old ones;

For promoting competitive efficiency in our productive machinery on a scale practiced by the nations competing in our markets at home and abroad;

For increasing national productivity;

For enabling business to offset, in some measure, the rising costs that would otherwise engulf the economy in a more serious cost push inflation than the one we now have.

An examination of the reasoning advanced for repealing the investment tax credit reveals only considerations of short term expediency. The rationale for the change is that the purposes the investment tax credit has served and is serving so well are not very important now and are not likely to become so again. So it is to be permanently revoked.

The role that the investment tax credit and a vigorous capital formation played in the U.S. economy the last six years and its potential for the long term future should not be so lightly dismissed.

Sober second thoughts should lead to a better answer to any of our current fiscal and monetary dilemmas than the permanent revocation of a device that has

served the nation so well in the past and is sure to be needed more often than not in the future.

Now, to add a few comments on the other two proposals affecting capital gains directly.

The nation and the Congress have long recognized that realized increases in capital risked for at least six months should be taxed at only one half the rate on ordinary income, and, in no event, should exceed 25 percent for any taxpayer (except in wartime).

Can anyone doubt that the end result of combining in one bill provisions eliminating this ceiling on capital gains and doubling the holding period will be less private capital put at risk and less mobility of risk capital and its unrealized gains from relatively safe untaxed shelters to the new or dynamic enterprises that do not have established credit or earnings?

Are new and small businesses more or less likely to find equity financing that provides an opportunity for growth with these changes in the law?

Could so-called black capitalism thrive or fluorish in the environment these new provisions would create except on the basis of government hand-out?

It is a striking paradox that the House bill puts a ceiling of 50 percent on the top marginal rate on earned income (a commendable action), while eliminating the ceiling on capital gains.

The two actions taken together are said to reduce the pressure to use tax shelters to convert ordinary income to capital gains from a 45 percent differential to 17½ percent.

Is it necessary to "throw out the baby with the bath"?

The way to prevent ordinary income from being converted to capital gains is to resist changes in law that have this effect. The other stated reason for eliminating the present ceiling on the taxation of capital gains is the variance with the progressive tax rate structure on ordinary income, permitting taxpayers with top marginal rates in excess of 50 percent in effect to include less than 50 percent of their capital gains into ordinary income.

In 1963 when President Kennedy sought to remedy this situation he sought a structural change that would do so but would also facilitate "our economic objectives". He recommended as the right approach to both objectives a decrease in the percentage of capital gains taxable for all taxpayers. The effect of this approach is to give the same character of progressivity to the taxation of capital gains as to ordinary income by increasing rather than decreasing the premium for risk investment.

President Kennedy recommended that the inclusion rate of capital gains into ordinary income be reduced from 50 percent to 30 percent which would have more than accomplished the restoration of progressivity to the taxation of capital gains.

In so doing he noted that:

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital and thereby the strength and potential for growth of the economy."

It should be observed that at the same time President Kennedy sought a significant reduction in the tax rate on capital gains he also recommended extending the holding period to one year, some definitional changes to minimize the treatment of ordinary income as capital gains and the taxation of capital gains accruing at the time of gift or death.

But the important fact that he stressed was the interrelationship of liberalization of the tax treatment of true capital gains with equitable adjustments, saying:

"I, therefore, recommend the following changes, the nature of which require their consideration as a unified package, coupling liberalization of treatment with more sensible and equitable limitations." (Underlining ours.)

A bill which includes only a harsher treatment of capital gains in both the rate of taxation and the holding period is neither consonant with our "economic objectives" nor adequate as a tax reform measure in the capital gains area.

The wise course is to remove those provisions from the House bill unless and until a formula can be devised that "couples liberalization of treatment" of capital gains "with more sensible and equitable limitations."

In closing, may I stress the fact that the responsibility of the United States Senate and its Finance Committee to review and revise the bill before it is far greater than that which attended its deliberations on the Revenue Acts of 1962

and 1964. In those bills the objective was structural change to provide both a sound but dynamic long term growth economy and equity between taxpayers. In its generally commendable, indeed necessary, effort to make our tax system more equitable, the House bill, at least in the three particular sections noted, seems to sacrifice tax policies established to provide a sound but dynamic growth economy to considerations of equity which are non-existent or marginal.

Is the Senate and its Finance Committee sure that the policies these three provisions would destroy, so painfully forged in the past, have outlived their usefulness for the 1970s?

Has some miracle been forged in the fires of war in South Vietnam that has so altered our economic system as to solve permanently the problem diagnosed by President Kennedy as recently as 1963?

Are the words he uttered then already obsolete—not only for the years of war and its accompanying inflation but for the years of peace ahead?

"The chief problem confronting the economy in 1963 is its unrealized potential—slow growth, underinvestment, unused capacity and persistent unemployment. The result is lagging wage, salary and profit income, smaller take-home pay, insufficient productivity gains, inadequate federal revenues and persistent budget deficits."

Are all those risks so far behind us that we can jettison the tools and techniques we used to overcome them?

It would seem the better part of wisdom to answer these questions in the context of a more normal peacetime economy than at present.

Long range tax policies designed to safeguard long term private investment in a tax structure still characterized by high rates on income should be maintained unless the most compelling reasons of equity require that they be abandoned.

To determine now that they are no longer useful or desirable—at a time of oncoming reconversion from a sizeable military effort when a rigorous program of fiscal and monetary restraint has already lowered the trajectory of real growth from excess demand half-way to a recession is to compound cyclical with structural risks.

It is for these reasons and against this background I would hope that the Committee and the Senate will insist upon the deletion from the Tax Reform bill of the three provisions singled out for this discussion.

Respectfully yours,

HENRY H. FOWLER.

TABLE 11.—TAX PROGRAM, CAPITAL GAINS AND LOSSES; ESTIMATED REVENUE EFFECT OF PROPOSED REVISION IN TAXATION OF CAPITAL GAINS AND LOSSES WHEN ALL PROPOSALS ARE FULLY EFFECTIVE

[In millions of dollars]

	Individual	Corporate	Total
1. Reduce inclusion percentage and extend holding period	−390	−40	−430
2. Allow indefinite carryover of losses	−20		−20
3. Tax gains accrued at time of gift or death	+300		+300
4. Change definition of capital gains	+70	+180	+250
Total, before induced effects	−40	+140	+100
Induced effects	+690	−40	+650
Total	+650	+100	+750

Source: Office of the Secretary of the Treasury; Office of Tax Analysis, February 6, 1963.

[Thereupon, at 12 noon, the committee recessed, to reconvene at 2 p.m. this same day.]

AFTER RECESS

The CHAIRMAN. Next we will call Mr. Thomas G. Corcoran, well known to all of us here.

The other Senators will be here shortly. We are happy to have you here before us.

Mr. CORCORAN. Thank you, Senator.

STATEMENT OF THOMAS G. CORCORAN, ESQ.

Mr. CORCORAN. For this appearance, I am not on retainer for any client. I have a long continuing interest in the capital development part of the U.S. economy which is not represented solely by publicly held securities in large corporations.

These nonpublic assets represent the largest aggregate producers of capital from savers, nonspenders in the country. They are different and of a greater value than all the publicly owned securities that we hear about.

There are many more assets into which as with their personal residences individuals have over a long period in the course of continuous development poured their hard-earned savings and sacrified their own time in further noncapitalizable improvement. Those other assets of the majority of the U.S. savers who have contributed to the capital base of the United States in developing it from an untamed wilderness, far exceed the assets of publicly owned securities. And their owners have taken the risks and liabilities of long-time ownership in the expectation that such taking of risks may after many years pay off in a capital appreciation.

I am appearing before the committee, although I have previously appeared before the subcommittee, because the approach to this problem has been taken up by the House in a form of the so-called Archer amendment which talks about "indexing" capital gains. It is because I think that there is a much better approach than that Archer amendment that I have come before the committee to ask it again to consider the principle that is established in S. 2608 introduced by Senator Bentsen for himself and Mr. Hansen.

This Bentsen-Hansen bill would provide a graduated exclusion from gross income for capital gains resulting from long-term holdings. It recognizes the principles of the 1934 act which, in Roosevelt's time until the beginning of the war, taxed capital gains on a scale graduated downward to 30 percent after a 10-year holding period.

The Bentsen-Hansen bill continues that scale downward to 20 percent during a 15-year period. It avoids the Treasury's management of the difficulty of indexing by making the downward graduation a specific percentage in the same amount for each year.

Two years ago, your committee itself further recognized this problem of a very long capital gain in view of the problem of inflation. Your committee voted a sliding scale for capital gains, depending on the length of time held. The recent special exemption from taxation on the sale of a residence is an attempt at the same problem.

Mr. Peter Grace of W. R. Grace Co., who is a good friend of labor, in his widely distributed appeal to the public against what he has called the disincentivation of America suggested, I think, a more reformed proposal of this idea. Appended to his statement are his advertisements in the Wall Street Journal.

Without going into specifics per year, Mr. Grace proposes a sliding scale which would lower the tax rate to zero for assets held over 10 years.

After hearing opposing arguments of the Treasury and appreciating its administrative difficulties, I would respectfully suggest that

that sliding scale not begin until after 5 years from the initial investment in the capital asset. That might assuage Treasury's apprehension over loss of capital gains receipts and the danger of the twisting of earned income into capital gains.

There are two most important reasons for such sliding scale treatment for investments which go back beyond 5 years. The first is related to the worst inflation in the Nation's history with no certainty of its immediate decline. Investors holding an asset for long periods, who invested dollars with earlier purchasing power usually under compulsion of external circumstances like age or a change in occupation, now sell for dollars with vastly less purchasing power than the dollars he invested.

In extreme cases, no matter what the quoted selling price, they might even be selling at a loss.

Other witnesses have elaborated on this.

The second, and equally important, reason is encouragement for the future of the taking of ownership risks in which continuing long-term investment is required to establish and work the bugs out of new ventures and ownership.

A capital gains tax which does not distinguish longterm and shorter term investment, when coupled with a continuing high rate of inflation, results in a confiscatory tax on assets sold after a long period of time.

These nonpublic assets represent the largest aggregate producers of capital from savers, nonspenders, in the country. They represent those who, over their lifetime, plowed back not only their savings but their efforts in development until, by external circumstances, like age, they are compelled, finally, to exercise their option to sell and to pay an excise tax on the exercise of that option in capital gains taxes to the Treasury.

For instance, a man may own a farm or ranch beyond the mere home dwelling on it or as was very common in the country I came from in New England, people may invest their money in two-family houses for rental. Or he may own a small business by himself or with a few partners, as the Ford enterprise was started, which gave labor its first real break in this country. Or he may be an employee owning stock, or options on stock, of his employer while he remains an employee, that "piece of the enterprise he works in, "which Senator Long speaks of.

On disposition of any of these the investor has to pay an accumulated capital gains tax on his one-time sale. Such tax not only confiscates the dollar purchasing power of the investment which the average American, not the millionaire, originally nurtured and improved by his time as well as his savings for a long-term holding. For the future, it discourages the new generation of taking that risk of venture for the future on which the whole development of this country has been based.

This country has been developed far less by those already millionaries as compared to the undistinguished host like everybody in this room who is trying to become a millionaire.

Let me face up to two objections. The first is an outworn attitude of the labor movement that it is immoral, that through the capital gains category of taxation money earned by money through capital investment can, under any circumstances, be taxed at a rate more

favorable than money earned by hands. That is a throwback from the old laws against usury.

I love my friend Andy Biemiller and I have worked with him for many years, and he testified this morning, but for the good of the man who works with his hands, that slogan of labor would appreciate rethinking in today's technological world.

What thoughtful men of labor and friends of labor like Peter Graves are increasingly understanding is that technical transformation of American industry through technological development was initiated by the needs of the war and communications and travel in outer space by satellites and trips to the Moon. It was redistributed to the whole world through our generation in the Marshall plan of foreign aid, and has since created a world-related economy.

In that economy, it is now obvious that there will be increasingly less work for American hands to do unless there is an increase in capital investment resulting in increasingly modern American plants and processes in which American willing hands can find work to do in an increasingly urban population, and an increasingly industrial world. The displacement of American manufactured goods by technologically superior factories created by technology and research by countries like Germany and West Germany, show the disappearance of work from American hands is a consequence of insignificant investment in plant and American research.

Unused capacity in U.S. plants today may be substantially related to the unused capacity of plants which are technologically inadequate, if not obsolete. A recognition in the tax laws of the encouragement of long-term risktaking promises more than technological acceleration in the United States, it means more jobs as the United States resumes becoming as much a producer as a consumer nation.

The second objection is that this possibly can turn out to be a bonanza for millionaries. The simple answer is that millionaires do not need it. When a man who owns a farm or ranch, sells a personally owned business or is a long-term owner of a favorite stock or a piece of the enterprise in which he works, he usually sells out not because he wants to, but because he has to. The most compelling factors are age, health, or unemployment problems.

A long-term employee owning stock that he has been permitted to buy in his company and is expected to keep it while he is employed, may have to sell the stock on retirement.

The owner of a small business who started with less capital than he can carry over a growth period may have to sell his business or a part of it to get additional capital or go bankrupt. Even the part owner of a publicly listed company may, as a practical matter, be forced to sell because a merger or tender offer.

The average market investor has contributed to the wealth of the Nation by savings taken usually from his earnings, leaving only the part required to sustain his standard of living. Furthermore, unless he is a professional accountant, he cannot be expected to itemize as an additional cost every capital improvement of an asset that he has paid for over a lifetime of ownership, and capitalize the value added by his personal labor or attention.

If there are people of wealth who own a diversity of assets, including some long-term holdings, their sale of capital assets is not likely to be compelled. Under professional management, their investments become

diversified. They can be skillfully managed under existing law to offset the gains by losses. They can make sales on an installment basis from year to year.

Wealthy people who do not have to sell to live as they wish may leave their assets to be disposed of as a part of their estate, subject to estate tax exclusions, at a time when gains of a lifetime can be equated against losses.

Praise God, nearly one-half of the business of law firms today is advice of that kind to rich clients as to management of their taxes. They, therefore, are not subject to the compulsion on the average man whose assets near the close of his life are concentrated in one undertaking.

For a democratic nation, obviously what we need to do, instead of demagoguing about millionaires, is to make a careful estimate of the relation between the immediate benefit of tax changes to the prosperous and the ultimate welfare of the less prosperous.

My own friend, Justice Holmes, who was a careful investor once had this answer to all those concerned about millionaires. In substance, he used to say that since, by definition, they are not necessitious, they cannot increase their standard of personal living and gratification in proportion to the additional wealth. If they eat in such proportion, they will get fat and heart disease. If they seek in proportion the delicious necessity of the company of beautiful women, they have to remember what the Chinese long ago symbolized by a single ideograph for every disaster in the world—earthquake, fire, tidal wave, everything—two women under one roof.

If those who want to be millionaires take advantage of a long-term capital gains tax to contribute capital gains to the Treasury, that is only lagniappe to the encouragement of ambition to risk on the part of that portion of the American public which are willing to save and risk their money and try to become millionaires.

The problem of adjustment between those who have too much and those who do not have too much is not the function of a capital gains tax, even with the political danger of envy.

Society's protection against abuses of the accumulation and concentration of wealth and the political danger of envy can be better handled by the estate tax the antitrust law and the labor law. Since the category was first created in U.S. tax law, the function of a capital gains tax is to encouarge investment of the Nation's savings in national productivity and jobs, to encourage capital investment which creates productivity, to make the risk worthwhile to the investor.

It has been very simple said, If you want the mule to pull the wagon, you have to feed the mule.

The CHAIRMAN. Thank you very much.

Senator Hansen?

Senator HANSEN. Let me say, Mr. Chairman, that I greatly appreciate the contribution that the distinguished witness has made here before the committee. He certainly draws upon a lifetime of experience. He has been very close to people in commanding positions of authority in this country for a long time, and I think the committee would be well advised to take most seriously the recommendations and observations he makes.

I thank him very much for his contribution.

Mr. CORCORAN. May I say, what I am talking about is supplementary to whatever else you do about capital gains. I completely agree with what Secretary Fowler said this morning. In a lifetime in which I sometimes doubt that I have done good or made trouble for the people, I take credit that I was the first to imperceptibly compel Mr. Fowler into public service.

Senator HANSEN. I salute you.

The CHAIRMAN. Mr. Nelson?

Senator NELSON. No questions.

The CHAIRMAN. Thank you very much for a very fine statement.

[The prepared statement of Mr. Corcoran follows:]

STATEMENT OF THOMAS G. CORCORAN

For this appearance I am not on retainer for any client. I have a long continuing interest in the capital development part of the U.S. economy which is not represented solely in publicly held securities in large corporations. In eight years with Mr. Jesse Jones' Reconstructions Finance Corporation. I was first given the task of finding a way to help small business. Thereafter, from a short time as Assistant to the Secretary of the Treasury in the Roosevelt Administration, and from service to the Congress in the financial proposals of the Administration, I learned to watch as Congressional policy from 1932 until the outbreak of the War trying to encourage investment in the capital markets. Since the end of the War, I have in private become deeply involved in the economic consequences of the difference between capital investment in the United States and in overseas competition with the United States.

For the record may I offer the statement on February 28, 1978, introducing Senate S. 2608 of Senator Bentsen for himself and Mr. Hansen. The Bentsen-Hansen bill would provide a graduated exclusion from gross income for capital gains resulting from long time holdings. A section of the House bill, the so-called "indexing" amendment, approaches from a substantially different point of view the same problem of inflation otherwise raised by the Bentsen-Hansen bill.

The Bentsen-Hansen bill, S. 2608, reorganizes the principle of a 1934 Act which in Roosevelt's time until the beginning of the War taxed capital gains on a scale graduated downward to 30 percent after a ten year holding period. The Bentsen-Hansen bill, continues the scale downward to 20 percent during a fifteen year period.

Since my time is limited, I would like to incorporate by reference my testimony on the Bentsen bill before the House Ways and Means Committee on March 21, 1973, before the Senate Committees on September 28, 1973, and February 6, 1974, and again this year before the House Ways and Means Committee on March 7, 1978.

The tax law has always made a distinction between short term and long term capital gains. The dividing line once six months is now one year.

Two years ago your Committee itself further recognized the distinction in voting a sliding scale for capital gains depending upon the length of time held. Your recent special exemption from taxation on the sale of a residence is along the same line, possibly country-wide the most popular of all tax proposals.

You are probably familiar yourself with the proposal of Mr. Peter Grace of W. R. Grace and Company (a good friend of Labor) in his widely distributed appeal to the public against what he has called the "Disincentivization of America." I have appended to this statement his advertisements in the Wall Street Journal. Without going into specifics per year, Mr. Grace proposes a sliding scale which would lower the tax rate to zero for assets held over ten years.

The judgment on specific rates and periods is for the Committee and the Congress. But after hearing opposing arguments of the Treasury and appreciating administrative difficulties, I would respectfully suggest that the sliding scale begin after five years from the initial investment in the capital asset. That might help Treasury's apprehension over loss of yearly capital gains.

(There is however good authority for believing the Treasury will actually receive per year a greater aggregate of capital gains taxes than before because more

owners of long term assets will be willing to exercise what is after all their option to sell.)

There are two most important reasons for such sliding scale treatment with investments that go back beyond five years.

The first reason is related to the worst inflation in the nation's history with no certainty of its immediate decline. An investor selling an asset held for a long period usually under compulsion of external circumstances like age or change of occupation who invested in dollars of earlier purchasing power is now selling for dollars with vastly less the purchasing power of the dollars invested. In extreme cases no matter what the "selling price" he may even be selling at a loss.

The second reason is encouragement for the future of the taking of ownership risks in which continuing long term investment is required to establish and work the bugs out of new ventures in ownership.

U.S. Government tax policy in the past has always urged—and Secretary Blumenthal continues to urge—that for the good of the national economy profits from invested capital be retained and reinvested over the long pull rather than be distributed in a dimunition of capital. This is exactly what the average American does with his lifetime's possibly sole investment his one "ewe lamb" thereby increasing the capital resources and the economic stability of the country. For this he should not be penalized on a once-in-a-lifetime cumulative capital gains tax increasing his earned income tax too.

As Senator Bentsen points out in his statement, $100 of purchasing power invested in 1967 is worth no more than approximately $60 in purchasing power today and $100 invested in 1947 when Mr. Truman was President has a purchasing power of approximately less than $40 today.

A recent edition of the Dow Theory Letter summarizes in a frightening way what a dollar at the time of Roosevelt's death in 1947 was worth at the end of each succeeding President's term:

President and dates:	*Cents*
Truman, January 1949 to January 1953	90.2
Eisenhower, January 1953 to January 1961	80.7
Kennedy/Johnson, January 1961 to January 1965	77.0
Johnson, January 1965 to January 1969	67.6
Nixon, January 1969 to August 1974	48.0
Ford, August 1974 to January 1977	41.0

On the same computation today in Mr. Carter's Presidency, the 1978 dollar is worth 38.0 cents and in the world market it constantly declines as the price of gold rises.

A capital gains tax which does not distinguish long term and short term investment when coupled with continuing high rate of inflation results in a confiscatory tax on assets sold after a long-time period.

There are many more assets into which as with their personal residences individuals have over a long period in the course of continuous development poured their hard earned savings and sacrificed their own time in further non-capitalizable improvement. Those other assets of the majority of the U.S. savers who have contributed to the capital base of the U.S. in developing it from an untamed wilderness, far exceed the assets of publicly owned securities. And their owners have taken the risks and liabilities of long time ownership in the expectation that such taking of risks may after many years pay off in a capital appreciation.

A man may own a farm or a ranch beyond the mere home dwelling on it or a two family house he rents. Or he may own a small business by himself or with a few partner investors. Or he may be an employee owning stock or options on stock of his employer while he remains an employee. These are instances of the kind of capital ownership which on disposition has to face a cumulative capital gains tax on their one-time sale. Such tax not only confiscates the dollar purchasing power which the average American not the millionaire, originally nurtured and improved with his time as well as his savings over a long term holding. For the future it discourages a new generation from taking the risk of venture for the future on which the whole development of this country has been based. This country has developed not by those already millionaires but the undistinguished host trying to become millionaires.

These non-public capital assets represent the largest aggregate producers of capital from savers, not spenders, in the country. They represent those who have over their lifetimes plowed not only their savings but their efforts in development until by external circumstances, like age, they are compelled to exercise

their option to sell. And it is an option whether they will pay that excise tax on the exercise of their option in capital gains tax or to the Treasury.

Let me face up to two objections.

The first is an outworn attitude of the Labor Movement that is unjust that through the capital gains category of taxation, money earned on money through capital investment can be taxed at a rate more favorable than money earned by hands.

For the good of the man who works with his hands that slogan would appreciate rethinking in today's technological world. What thoughtful men of Labor and friends of Labor like Peter Grace are increasingly understanding is the technical transformation of American industry through technological developments. This was initiated by the needs of the war and communications and travel in outer space like satellites and the trip to the moon. It was redistributed to the whole world through our generosity in the Marshall Plan and foreign aid and has created a world related economy. In that economy there will be increasingly less work for American hands to do unless there is an increase in capital investment resulting in increasingly modern plants and processes in which American willing hands can find work to do in an increasingly urban population and an increasingly industrial world.

The displacement of U.S. manufactured goods by products of technologically superior factories created by adequate capital investment and research in countries like Germany and Japan show clearly that the disappearance of work for hands is clearly in part a consequence of insufficient capital investment in plants and research. Unused capacity in U.S. plants today may be substantially related to the unused capacity of plants which are technologically inadequate if not obsolete.

A recognition in the tax laws of the encouragement of long term risk taking promises a technological acceleration in the U.S. which means more jobs as the U.S. resumes becoming a productivity nation.

The second objection is that this will be a bonanza for millionaires. The answer is millionaires don't need it.

When a man who owns a farm, a ranch, a personally owned business or is a long term owner of a favorite stock sells, he usually sells not because he wants to but because he has to. The most compelling factor may be age, health or employment problems.

A long time employee owning stock he has been permitted to buy in his company and is expected to keep while he is employed may have to sell such stock on retirement for funds to retire on.

The owner of a small business who started with less capital than can carry it over a growth period may have to sell his business or part of it to get necessary addiitonal capital—or go bankrupt.

Even a part owner of a publicly listed bigger company may as a practical matter be forced to sell because of a merger or a tender offer.

The moderate investor has contributed to the wealth of the nation by savings taken usually from his earnings leaving only the part required to sustain his standard of living. In most cases, even if he is a professional accountant, he cannot itemize as an additional cost every capital improvement of an asset he has paid for over a lifetime of ownership let alone capitalize the value added by his personal labor or attention.

There are, of course, persons of wealth who among a diversity of assets have some long-term holdings. But their sale of capital assets is not likely to be compelled. Under professional management their investments are diversified. They can be skillfully managed under existing law to offset gains by losses. They can make sales on an installment basis from year to year. And it is no accident that nearly one-half of the business of law firms today is advice to rich clients as to the management of taxes.

Or wealthy people who do not have to sell to live as they wish can leave their assets to be disposed of as a part of their estate subject to estate tax exclusions and at a time when gains of a lifetime can be equaled against losses. They are not therefore subject to compulsions on the average man whose assets near the close of his life are concentrated in one undertaking or asset.

Despite their options to handle their portfolios without its assistance, it may happen that a few "wealthy" may sell securities held more than five years taking advantage of such a graduated capital gains tax. Even more likely, a few young professional people building their first investment in their first few securities—managing their own assets because they are unable to give their invest-

ments professional attention—may similarly take advantage of a graduated tax. But these are minor in number and "unlocking" long-held securities for reinvestment by such sales would create mobility of capital available to the general capital market.

Such mobility of capital would be a real advantage to the general economy in the consequent reinvestment in new ventures which all agree are the growing point of increased employment. Such mobility of capital would also encourage other capital investment by helping stabilize a bull or bear market and keeping it from getting out of hand in discouraging that kind of excessive fluctuation which frightens the small investor and keeps his money in a mattress or in a savings account.

For a democratic nation, obviously what we need to do is to make a careful trade-off between the immediate benefit of such tax changes for the prosperous and the ultimate welfare of the disadvantaged. But events of the past quarter century show there is long term paydirt in policies not inhibiting the drive of those people who are risking ulcers of the stomach trying to become millionaires. Those trying to become millionares of U.S. industry are a cardinal motive force of a capitalist economy. They are the mules who pull the wagon. They are the risk takers, the often compulsive workers, the avid seekers of new technology and managerial innovation, the performers who set the highest standards of achievement and excellence. If, as has been said, they also include a few crooks, there are poor crooks too.

If, therefore, as a consequence of such amendment of the tax laws, a few millionaires decide to take advantage of the disposition of long term holdings and so unlock for new investment that frozen capital which their financial station does not compel them to unlock, the economy gains far more in immediate infusion of capital in new industry and new jobs than the rich man's manipulation against the eventuality of an estate tax.

My old friend Justice Holmes who was himself a careful investor once had this answer to all the concern about millionaires. In substance he used to say since by definition they are not necessitous, they cannot increase their standard of personal living in proportion to their additional wealth. If they eat in such proportion, they will get fat and heart disease. Of necessity, the bulk of the extra money goes into investment or in that market for government securities which permits government borrowing for the government's social policies. Suppose if in conjunction with justice for the average investor beset by inflation and necessity even the few who hope to become millionaires take advantage of a long term capital gains tax and so sell their assets to contribute capital gains to the Treasury, it is only lagniappe for the maintenance of justice to the encouragement of ambition to risk on the part of that portion of the Americcan public who are willing to save and risk their savings.

Essentially, the so-called capital gains tax is only an *excise* tax on the sale of a particular piece of property, effective when an owner decides to exercise his option to sell (and no capital gains is payable to the Treasury until he does exercise that option). It is not a tax on a man's lifetime capital position. The only tax that truly measures that lifetime capital position is the estate tax. And the estate tax, not the capital gains tax, is society's protection against abuses of the accumulation and concentration of wealth.

That is not the function of a capital gains tax. The function of a capital gains tax is to encourage investment of a nation's savings in national productivity and jobs. And to encourage capital investment which creates productivity, you have to make it worthwhile to the investor. It has been simply said, "If you want the mule to draw the wagon, you have to feed the mule."

Revenue Act of 1934

SEC. 117. CAPITAL GAINS AND LOSSES

SEC. 117(a) General Rule. In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year:

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital assets has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

CAPITAL GAINS TAXES IN OTHER COUNTRIES

An editorial in the Wall Street Journal of May 8, 1978, has the following information as to capital gains taxes in other countries:

Country and top rate:	*Holding period*
United States, Just over 49 percent *	1 year.
Australia, Exempt	1 year.
Belgium, Exempt	None.
Canada, 22 percent *	None.
Germany, Exempt	6 months.
Italy, Exempt	None.
Japan, Exempt	None.
Netherlands, Exempt	None.
Sweden, 23 percent *	2 years.
United Kingdom, 30 percent	None.

*Excluding State and Local Taxes.

The prestigious National Bureau of Economic Research has developed some new data that throws additional light on the impact of the increase in capital gains taxes from the 25 percent maximum level that prevailed up to 1969. The following comparison net capital gains realized, i.e., taken during the two years 1967–1968 before the increase in the capital gains tax with the net capital gains in the latest available years, 1975–1976.

COMPARISON OF NET CAPITAL GAINS FOR 1967-68 AND 1975-76

Adjusted gross income	Amount 1967-68 (billions)	Amount 1975-76 (billions)	Percentage change
Less than $100,000	$11.47	$13.52	7.9
$100,000 to $500,000	3.14	2.76	(12.1)
More than $500,000	2.12	1.38	(34.9)

The National Bureau interprets these data as an indication that the highest income individuals were much less likely to realize gains after the Tax Reform Act of 1969 than before.

In the higher income brackets there were sharp reductions in capital gains realized, i.e., a decline by (12.1) in the bracket of $100,000 to $500,000 adjusted gross income and a decline of (34.9) in the bracket above $500,000 adjusted gross income. Thus, the higher income bracket are where there has been the greatest reluctance to take capital gains and thus where federal revenues from capital gains taxes have been most adversely affected by higher tax returns. The higher the capital gains tax the less gain there is to tax and the less capital there is for new venture. The Bureau's analysis continues with the following:

NET CAPITAL GAINS AS A PERCENTAGE OF ADJUSTED GROSS INCOME NET OF GAINS, 1967-68 AND 1975-76

Adjusted gross income	1967-68	1975-76	Percentage change
Less than $100,000	2.36	1.42	(39.8)
$100,000 to $500,000	37.4	9.72	(74.0)
More than $500,000	154.7	36.3	(76.5)

These data are especially compelling in showing that at all income levels the percentage of capital gains sales to adjusted gross income excluding a capital gains declined from the two year period 1967–1968 to the two year period 1975–1976 and these declines are in a very large magnitude, i.e., in the range of (39.8) to (76.5).

The Bureau's report states "while there has been a large decrease in the gain percentage for all groups, the upper two groups decline shows far more extreme than the lowest income group." The Bureau's report states: "In sum, we can detect evidence of a lock-in effect of the accumulated data on net gains from capital assets. The lock-in means that the government's tax take is reduced. Conversely, it follows that with a reduction in the capital gains tax, more capital would be realized and the government's tax revenues boosted."

TAXES ARE TAKING THE FREEDOM OUT OF FREE ENTERPRISE

Investment is the lifeblood of the free enterprise system. But heavy taxes on investment dollars have reduced the incentive to invest in American business. As a result, our country has experienced a declining rate of productivity and other forms of economic deterioration.

At W. R. Grace & Co., we think this trend can be reversed. The ads reprinted below contain constructive suggestions designed to free American business from a constricting lack of capital.

Please take a moment to read them. Then write your elected representative today so he knows how you feel when he votes.

LET'S STOP TAXFLATION BEFORE IT BRINGS OUR ECONOMY TO A STANDSTILL

A recent issue of a major business publication carried this statement.

"*Stockholders be damned:* Some big firms oppose tax relief for shareholders.

"Congress has practically ignored a proposal to 'end double taxation' on dividends: once as corporate income, again as dividend income to shareholders."

The article then quoted a congressional committee aide as saying:

"Corporate managements don't have shareholders' interests at heart."

Well, here's one corporate management that does have its shareholders' interests at heart, especially when taxation and inflation are striking at the very roots of our society and our economy.

We believe that shareholders tax relief is urgently needed.

And double taxation of dividends isn't the only problem. For certain tax brackets, capital gains are taxed three times.

They're taxed once through the computation of regular taxes. Then, because they're a tax preference item, they're taxed again—this time by reducing the amount of salary or wages eligible for treatment as earned income subject to the advantages of a 50 percent tax ceiling. Finally, they're taxed a third time through the so-called minimum tax.

To make matters worse, inflation erodes the real value of dividends or capital gains. As a result, much of what the shareholder receives is nothing more than illusion.

Taxflation—the combination of taxation and inflation—is destroying all we work for:

If income stays the same, purchasing power declines. A dollar put away in 1965 buys only 50 cents today.

If income keeps pace with inflation, the wage earner finds himself in increasingly higher tax brackets which more than offset gains in purchasing power.

What's our program for stopping taxflation? We suggest you write the Chairman of the House Ways and Means Committee, the Chairman of the Senate Finance Committee, or your elected Senators and Representatives, and tell them to:

1. Stop the unprecedented government deficit spending which has become a major cause of inflation.

2. Stop double taxation of dividends by excluding dividend income from federal taxation—at least to some reasonable annual amount, like $1,000 or $2,000 per taxpayer.

3. Reduce short-term capital gains tax to a maximum of 25 percent and, on a sliding scale, lower that tax rate to zero for assets held over ten years.

An economy which depends on private capital for growth can't afford to bite the hand that feeds it. And taxflation is doing just that.

Writing your Congressman to stop taxflation is one way to make sure our economy continues to make sense.

One step ahead of a changing world. Grace chemicals, natural resources, consumer products.

W. R. Grace & Co., 1114 Avenue of the Americas, New York, N.Y.

LET'S GIVE INVESTMENT A CHANCE WHILE THERE'S STILL SOMETHING LEFT TO INVEST

The combination of taxes and inflation has all but destroyed the incentive to invest in the American economy. And recent proposals to raise capital gains taxes would further reduce that incentive.

We call this process "disincentivization." And, as you can see from the table below, it's bringing business investment and economic growth to a standstill:

[In percent]

	Capital gains tax rate		Real U.S. investment growth rate (Average of 5 years ending on year shown)	Real GNP growth rate (Average of 5 years ending on year shown)
	Maximum	Based on $75,000 gain		
1968	25.0	25.0	8.0	4.8
1973	35.0	27.5	3.9	3.3
1977	49.1	30.6	1.7	2.7
1979	[1] 52.5	[1] 36.5	?	?

[1] Per the administration's tax reform proposal

As tax rates on capital gains increase, investment and economic growth rates decline.

At W. R. Grace & Co., we think the best way to trigger new investment is to reduce the tax on capital gains.

According to Chase Econometrics Associates, a reduction in the maximum tax rate on capital gains to 25 percent would free billions of dollars for investment in American business. Enough to create some 440,000 jobs. Enough, in fact, to produce $16 billion in added tax revenues by 1985.

What's more, we can further stimulate investment by reducing taxes on dividends.

The present law taxes dividends twice—once as corporate income, then as dividend income to investors. Reducing the taxes on dividend income would free more capital, increase productivity, and create even more jobs.

How can investors—both large and small—get the tax relief they need to keep our economy growing? We suggest you write the Chairman of the House Ways and Means Committee, the Chairman of the Senate Finance Committee, or your elected Senators and Representatives, and tell them to:

1. Reduce the short-term capital gains tax to a maximum of 25% and, on a sliding scale, lower that tax rate to zero for assets held over ten years.
2. Stop double taxation of dividends by excluding dividend income from federal taxation—at least to some reasonable annual amount, like $1,000 or $2,000 per taxpayer.
3. Stop unprecedented government deficit spending which has become a major source of inflation.

An economy which depends on private capital for growth can't afford to bite the hand that feeds it. And increasing taxes on investment dollars would do just that.

Writing your Congressman to lower investor taxes is one way to make sure our economy continues to make sense.

One step ahead of a changing world.

GRACE CHEMICALS, NATURAL RESOURCES, CONSUMER PRODUCTS.

TAXES UP. PRODUCTIVITY DOWN. COULD WE BE DOING SOMETHING WRONG?

America can no longer afford to ignore the fact that its productivity has fallen behind.

And, as you can see from the table below, compared to other countries, taxes on investor capital have retarded U.S. growth in productivity and in GNP:

	1977 maximum capital gains tax (percent)	Economic performance, 1962-77		
		Investment as a percent of GNP	Average annual percent increase in productivity	Average annual percent increase in real GNP
Japan	0	32.0	8.4	8.3
France	0	22.8	5.7	4.8
Netherlands	0	23.7	6.9	4.6
Belgium	0	21.8	6.9	4.0
Germany	0	24.8	5.5	4.0
United States	49.1	17.5	2.7	3.5

High productivity requires a high level of investment for plant and equipment. But investment as a percentage of GNP (17.5 percent) is lower in the U.S. than in any of the other countries shown above.

The reason is simple. An increasing capital gains tax rate has reduced the profitability of equity investment. With inflation compounding the problem, investors have fled the market. The result has been a marked drop in capital formation—especially for small companies:

CAPITAL RAISED BY COMPANIES HAVING A NET WORTH OF UNDER $5,000,000

Year	Number of offerings	Funds raised (in millions)
1969	698	$1,367
1971	248	551
1973	69	160
1975	4	16
1977	30	118

Between 1969 and 1977, offerings dropped a staggering 95.7 percent. At W. R. Grace & Co., we think the best way to stimulate investment and productivity is to reduce the tax burden on investors. Yet, recent proposals to raise capital gains taxes would further reduce the incentive to invest.

Experts argue that a reduction in the maximum tax rate on capital gains to 25 percent would free billions of dollars for investment in American business. Enough to create some 440,000 jobs and to produce $16 billion in added tax revenues by 1985.

How can investors—both large and small—get the tax relief they need to keep our economy growing? We suggest you write the Chairman of the House Ways and Means Committe, the Chairman of the Senate Finance Committee, or your elected Senators and Representatives, and tell them to:

1. Reduce the short-term capital gains tax to a maximum of 25 percent and, on a sliding scale, lower that tax rate to zero for assets held over ten years.
2. Stop double taxation of dividends by excluding dividend income from federal taxation—at least to some reasonable annual amount, like $1,000 or $2,000 per taxpayer.
3. Stop the unprecedented government deficit spending which has become a major source of inflation.

An economy which depends on private capital for growth can't afford to bite the hand that feeds it.

Writing your Congressman to lower investor taxes is one way to make sure our economy conitnues to make sense.

One step ahead of a changing world. Grace chemicals, natural resources, consumer products.

THE SMALL INVESTORS AN ENDANGERED SPECIES

You don't have to be a millionaire to have a stake in the capital gains tax debate.

Small investors—indeed, all Americans—will be directly affected by this issue. And it's quickly coming to a head.

On the one hand, there are those who favor proposals to reduce the maximum tax rate on capital gains.

The Administration, on the other hand, rejects these proposals, claiming they would bring windfall profits to the rich, while leaving the average American in the lurch.

But the facts are that nearly two-thirds of total capital gains are realized by individuals with adjusted gross incomes of under $50,000. At W. R. Grace & Co., it is precisely the small investor we want to support. The individual whose right to property is being threatened by inflation and taxes. Each of these investors would benefit from the proposals, and all Americans would share in the other economic benefits which would result from reduced capital gains taxes.

Consider the following:

Over the past ten years, the U.S. economy has steadily deteriorated, as shown in the table below:

THE DETERIORATING U.S. ECONOMY
[5 Years ending in year shown]

	1968	1973	1977	Percent deterioration 1968–77
Real GNP (average annual percent change)	4.8	3.3	2.7	(43.8)
Unemployment rate (Average percent)	4.2	5.0	6.7	(59.5)
Real business investment (average annual percent change)	8.0	3.9	1.7	(78.8)
Inflation (average annual percent change)	2.6	5.0	7.7	(196.2)
Federal deficit (average, dollar amounts in billions)	($4.7)	($9.9)	($38.2)	(712.8)
Maximum capital gains tax (single year rate) (percent)	25.0	45.0	49.1	(96.4)

Reversing these economic trends will require vigorous and productive investment in American business.

Yet, the combination of 50 percent capital gains tax and 7 percent inflation has made it exactly 2.4 to 3.1 times tougher now to realize the same real profit from an investment than it was in the mid-sixties.

This increased investment risk has all but crushed the incentive to invest. So much so that individual participation in equity markets declined 26 percent between 1968 and 1976. Like an endangered species, the choice for the small investor has been: flight or fight. So far, he has fled.

A deteriorating economy affects every American, regardless of income level or tax status.

Our point is simple and obvious. The best way to stimulate investment—and hence the economy as a whole—is to reduce the taxes that are forcing investors to turn away from equity markets.

Some experts say that reducing the maximum capital gains tax rate to 25 percent would free billions of dollars for productive investment. Enough to create some 440,000 jobs. Enough, in fact, to add $16 billion to federal revenues by 1985.

If you, too, think the small investor is an "endangered species" we urge you to write the Chairman of the House Ways and Means Committee, the Chairman of the Senate Finance Committee, or your elected Senators and Representatives, and tell them to:

1. Reduce the short-term capital gains tax to a maximum of 25 percent and, on a sliding scale, lower that tax rate to zero for assets held over 10 years.
2. Stop double taxation of dividends by excluding dividend income from federal taxation—at least to some reasonable annual amount, like $1,000 or $2,000 per taxpayer.
3. Stop the unprecedented government deficit spending which has become a major source of inflation.

An economy which depends on private capital for growth can't afford to bite the hand that feeds it. And heavy taxes on investment dollars are doing just that.

Writing your Congressman to lower investor taxes is one way to make sure our economy continues to make sense.

One step ahead of a changing world. Grace, chemicals, natural resources, consumer products.

The CHAIRMAN. Next, we will call Mr. Edwin S. Cohen on behalf of the Investment Company Institute, accompanied by Matthew P. Fink, general counsel.

We are happy to have you here.

STATEMENT OF EDWIN S. COHEN, ESQ., ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE; ACCOMPANIED BY MATTHEW P. FINK, ESQ., GENERAL COUNSEL, INVESTMENT COMPANY INSTITUTE

Mr. COHEN. Thank you, Mr. Chairman. I thank you for the opportunity to appear today on behalf of the Investment Company Institute, of which Mr. Fink, who is accompanying me, is the general counsel.

The Investment Company Institute is the national association of the mutual fund industry. It has among its membership about 470 mutual funds and their investment advisers and principal underwriters. In the aggregate, these mutual funds have $50 billion in assets and some 7 million shareholders. Thus the average shareholder has an account of about $7,000. The companies are regulated by the SEC and they are known in the Internal Revenue Code as regulated investment companies.

We appear today to call your attention to a matter that would seriously affect the investment company mutual fund industry. It arises in section 404 of the bill relating to indexing of common stocks, tangible personal property and real property. The provision would index the cost of these assets for inflation occurring after 1979.

Our problem is that while the bill would permit the mutual funds themselves to index their investments in the common stocks they own in their portfolios, the bill as it is presently drawn would not extend this right of indexing to the shareholder for his stock investment in the mutual fund.

We think that it is important that the right of indexing be extended to the shareholders in order to make the system work. The mutual funds are taxed under existing law—and have been since 1936—essentially as conduits, in that if they distribute all of their investment income and their capital gains to their shareholders, no tax is imposed on the mutual fund, but the shareholders pick up the investment income and capital gains in their own returns and pay taxes on them just as if they had invested directly.

Since the mutual funds represent an alternative means for a person to invest in securities and give him the benefit of diversification of risk and expert investment management, an expense that he could not otherwise afford, it is essential that the tax burdens on the companies not be greater than that on a person investing directly, or otherwise the companies could not long exist.

Following that principle, we think that when the matter of indexing is introduced into the code, it is important that it be available to those who invest by pooling their funds with others as well as those who invest directly.

In my written statement I have submitted examples that show that, at least when a mutual fund is fully invested in common stocks which are indexed, it is proper and appropriate to permit indexing of the shareholder's investment in the fund.

I will not bother you with the illustrations at the moment, but I think that it becomes apparent on analysis although it might, at first blush, not be seen.

The other problem that may exist is that some mutual funds may own, in addition to common stocks, bonds or preferred stocks that would not be subject to indexing if they were owned directly; and to that extent, it seems to us that indexing should not be permitted to those investing in bonds or preferred stores through mutual funds. We have made a survey of the mutual fund industry. We find that the funds are grouped at two extremes, largely. More than half of the funds have more than 80 percent of their assets invested in common stocks, and we would suggest that at least those should be eligible for indexing at the shareholding level.

At the other end there is a quarter of the industry investing in bonds largely, and those we think should not be eligible for indexing.

We need to devise some rule for those funds falling in between. We make two suggestions in our written statement, and we would appreciate the opportunity of conferring with the staff about the alternative rules that we suggest.

One suggestion, for example, would simply provide that if the fund has more than half of its assets invested in common stocks, its shares would be subject to indexing in the hands of the investor. On the other hand, if it has less than half of its assets invested in common stocks, its shares would not be subject to indexing. But there are some alternative suggestions that we have made.

May I close by saying that while this may seem to be a technical matter, it is of vital importance to the mutual fund industry because, as I have indicated, if indexing were permitted to those who could afford to invest directly but not permitted for those who invest in mutual funds, the mutual funds would be at a serious disadvantage and so would be the investor of moderate means.

So we would hope, Mr. Chairman, that our request would be granted. We hope that we can work out with the staff a rule that would take care of the case where the mutual fund has part of its assets invested in assets that are available for indexing and part that is not.

Thank you, sir.

The CHAIRMAN. You make a good point, Mr. Cohen, and I want to instruct the staff so that this point does not escape our notice in the event that we do keep the indexing provision in here. Your point should be taken care of. I think it would be inequitable not to, and I would want the staff to be sure that we do consider this point when we get to it.

Thank you very much.

Are there any questions, Senator Nelson?

Senator NELSON. No.

The CHAIRMAN. Thank you very much, sir.

[The prepared statement of Mr. Cohen follows:]

STATEMENT OF EDWIN S. COHEN ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling, of Washington, D.C. I thank the Committee for the opportunity to appear before it today on behalf of the Investment Company Institute. I am accompanied by Matthew Fink, General Counsel of the Institute.

The Investment Company Institute is the national association of the mutual fund industry. Its membership includes some 470 mutual funds, and their investment advisers and principal underwriters. Its mutual fund members have over 7 million shareholders and assets of some $50 billion, representing more than

90 percent of the assets of all U.S. mutual funds. The average mutual fund shareholder account is approximately $7,000. Mutual funds are referred to in the Internal Revenue Code as "regulated investment companies."

The Institute respectfully calls to the attention of the Committee a problem in the "indexing" provision in Section 404 of H.R. 13511 that in its present text would have a most serious adverse effect upon the shareholders of mutual funds. We think the problem can fairly readily be solved.

Section 404 of the bill provides for the indexing of certain assets for inflation occurring after 1979 in determining gain or loss on the sale of these assets. That section permits indexing for inflation in the case of common stock, tangible personal property and real property. (Sec. 404(b)(1).) However, it specifically and totally excludes from the category of common stocks any stock in a "regulated investment company." (Sec. 404(b)(2)(A)(ii).) It is this exclusion which we believe is incorrect, both as a technical and practical matter, and which would seriously affect the mutual fund industry.

Mutual funds are corporations which furnish an investment medium by means of which individual investors pool their funds to acquire collectively a portfolio of investment securities. The individual investor, along with other investors, purchases common stock in the mutual fund corporation, and the corporation applies the funds paid into it to purchase a diversified portfolio of securities which are managed under the supervision of an investment advisor. The mutual funds thus are of particular advantage to an investor of moderate means who could not otherwise achieve diversification of risk or obtain professional investment management without undue expense. The funds and their advisors are regulated by the Securities and Exchange Commission.

Mutual funds provide an investment medium that is an alternative to direct investment. If mutual funds and their shareholders were subjected to a heavier burden of federal income taxation than would be incurred by individuals if they made direct investments in securities, the funds could not long exist.

In recognition of this circumstance the Internal Revenue Code since 1936 has contained provisions, now found in Subchapter M, under which mutual funds in essence are treated for income tax purposes as conduits: the mutual funds are not subjected to corporate income tax if they distribute currently to their shareholders all of their net investment income from dividends and interest received on their security holdings and also distribute all of their net capital gains. The shareholders include in their tax returns as ordinary income the amounts distributed to them out of net investment income and include as long-term capital gains the "capital gain dividends" distributed to them out of net long-term capital gains realized by the corporation. In this manner there is no additional tax and no lesser tax incurred than if the individual invested directly.

Section 404, as it presently appears in the bill, would upset this balance by extending the right to index for inflation to persons investing directly in common stocks but deny the right to persons investing through mutual funds. The report of the Ways and Means Committee indicates that the right to index was denied in the case of mutual fund shares (and to other "conduit" entities, such as real estate investment trusts, bank common trust funds, partnerships, etc.) for two reasons:

(1) Since the mutual fund would be given the right to index its own portfolio holdings of common stock, it was thought unnecessary to index the shareholder's holding of common stock in the mutual fund; and

(2) Since the indexing proposal would not apply to holdings of bonds and preferred stock, and since the mutual fund might own such securities, indexing of stock in mutual funds would be inappropriate since it might in some cases permit indexing of an indirect interest in bonds or preferred stock.

We respectfully submit that on reflection it will be seen that these conclusions are not correct and that, accordingly, Section 404 requires amendment.

1. Let me illustrate the first point with a simple case. Assume that 100 individuals each invest $1,000, a total of $100,000, in a newly organized mutual fund. The fund invests the $100,000 in a diversified portfolio of common stocks. The fund assets rise in value in four years to $120,000, during which period the inflation index rises 20 percent. If the fund then sells its entire portfolio and hence has a $20,000 nominal gain, indexing will leave the fund with no taxable gain but with $120,000 in cash. If the fund retains the $20,000 nominal gain, each individual will have stock in the mutual fund with a cost of $1,000 and a value of $1,200; and if he then redeems his entire interest in the mutual fund he will have a $200 taxable gain, with no allowance for the 20 percent inflation. If, however, he were allowed to index, he would have no taxable gain, just as would be the case if he had invested directly.

If the fund distributed the $20,000 nominal gain to its shareholders, the committee report makes clear that it would be a return of capital to the shareholders, with the result that each shareholder would reduce his cost for his mutual fund stock from $1,000 to $800; and if he then redeemed his stock for the $1,000 that represents his share of the assets remaining in the company, he would still have a $200 taxable gain under H.R. 13511 as it is presently written, with no allowance for the 20 percent inflation. If the shareholder were allowed to index, his $1,000 cost would be indexed up to $1,200; it would be reduced to $1,000 by the $200 distribution from capital; the shareholder would have no taxable gain or loss on the redemption of his shares; and this would be the same result as would occur if he had invested directly.

We think this example illustrates the point that for the proper functioning of indexing in the case of mutual funds—and we believe also in such similar aggregations of investments as bank common trust funds, real estate investment trusts, etc.—it is necessary to index the individual's investment in the fund as well as the fund's investment in its assets, at least where the fund is fully invested in assets that qualify for indexing.

2. Many mutual funds invest solely in common stocks. Some invest solely in bonds, or solely in bonds and preferred stocks. Some invest in all three types of securities. The Institute has surveyed the data reported to it by its member mutual funds as of December 31, 1977. As will be seen from the summary of the data attached to my statement (Exhibit I)—

a. Funds owning more than 40 percent of the aggregate assets of all the funds have more than 90 percent of their net assets[1] invested in common stocks.

b. Funds owning more than 50 percent of the aggregate assets of all of the funds have more than 80 percent of their net assets invested in common stocks.

c. Funds owning some 72.5 percent of the aggregate assets of all the funds have more than 50 percent of their net assets invested in common stocks.

d. Funds owning some 22 percent of the aggregate assets of all the funds have less than 10 percent of their net assets invested in common stocks.

As I noted earlier, it would be incorrect to deny to an individual the right to index his shares in a mutual fund if substantially all the assets of the mutual fund are invested in common stocks. Correspondingly, if one looks through to the assets of the mutual fund, indexing should not be permitted to the shareholder of a mutual fund that is fully invested in bonds as long as bonds directly owned are not subject to indexing.

On reviewing the data summarized in Exhibit I, it would seem that the simplest rule would be to allow indexing at the shareholder level if the fund's assets are more than 50 percent invested in common stocks and to deny indexing at the shareholder level if the fund's assets are less than 50 percent so invested. Another possible rule would be to allow full indexing at the shareholder level if the fund's assets are more than 80 percent or 70 percent invested in common stocks, deny indexing where it is less than 20 percent or 30 percent so invested and allow pro rata indexing for the funds that fall in between.[2] We would be pleased to have the opportunity to work with the staff in developing the appropriate rate.

In closing, let me emphasize the importance of this issue to the $50 billion mutual fund industry, since the use of mutual funds as an investment medium for some 7 million investors would be seriously undermined if indexing would be available for direct investments in common stocks but not for investments made in common stocks through mutual funds. As I have noted, I think a comparable issue would be involved for other investment media, such as bank common trust funds and real estate investment trusts. The details of the indexing provision were not available until after H.R. 13511 was reported to the House on August 4, 1978, and we believe that in the further time that is now available for considera-

[1] Since mutual funds generally have only common stock outstanding and relatively little current liabilities, net assets are not materially less than gross assets. The only data readily available is in terms of net assets.

[2] In a somewhat comparable situation, involving the eligibility of dividends paid by mutual funds for the $100 dividend exclusion, Section 854 allows the full dividend exclusion if more than 75 percent of the gross income (excluding capital gains) of the mutual fund is derived from dividends received by it, and accords pro rata eligibility to the dividends paid by the mutual fund if its dividends received represent less than 75 percent of the gross income (excluding capital gains) received by it. See Supplemental Memorandum attached, item 3.

tion of the bill by the Committee on Finance a solution can readily be found along the lines that we have suggested.

EXHIBIT I

MUTUAL FUNDS REPORTING TO THE INVESTMENT COMPANY INSTITUTE CLASSIFIED BY THE PERCENTAGE OF TOTAL NET ASSETS INVESTED IN COMMON STOCK, DEC. 31, 1977

Percent of total net assets in common stock	Number of funds	Percent distribution	Value of common stocks (thousands of dollars)	Value of net assets (thousands of dollars)	Percent distribution
0 to 9	122	30.4	$16,624	$10,234,427	21.9
10 to 19	6	1.5	67,101	474,280	1.0
20 to 24	5	1.2	101,826	485,668	1.0
25 to 29	5	1.2	93,677	345,375	.7
30 to 39	6	1.5	116,869	346,788	.7
40 to 49	10	2.5	269,876	576,362	1.2
50 to 59	20	5.0	2,090,146	3,813,502	8.2
60 to 69	27	6.7	1,265,549	1,900,440	4.1
70 to 79	37	9.3	3,711,903	4,993,539	10.7
80 to 89	52	13.0	3,986,534	4,706,202	10.1
90 and over	111	27.7	17,884,884	18,927,830	40.4
Total	401	100.0	29,604,989	46,804,413	100.0
Fund not reporting common stock data	68		1,141,011	2,092,596	
Total all funds reporting to institute	469		30,746,000	48,897,009	

SUPPLEMENTAL MEMORANDUM TO STATEMENT OF EDWIN S. COHEN ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

1. In the example given in the principal statement, (pp. 4–5), it was assumed for purposes of simplicity that all the shareholders entered the mutual fund at the same time upon its organization. The same conclusion would be reached with respect to shareholders who acquire shares in the fund at a later time. Assume, for example, the following facts:

a. As in the first example, 100 shareholders (Group A) each invest $1,000, a total of $100,000, in a newly organized mutual fund on January 1, 1980. The fund purchases a diversified portfolio of common stocks for $100,000

b. Assume the consumer price index is at a level of 100 on January 1, 1980, at a level of 110 on January 1, 1982 and at a level of 120 on January 1, 1984.

c. Assume that the investment portfolio of the fund had risen to a value of $110,000 on January 1, 1982. At that time 100 other individuals (Group B) each invested $1,100, a total of $110,000, in the mutual fund, obtaining thereby a one-half interest in a fund worth $220,000.

The fund then invests the newly received $110,000 in a diversified portfolio of additional common stocks, giving it a total portfolio value of $220,000.

d. Assume that on January 1, 1984, fund assets have risen in value to $240,000 and are sold for cash in the amount of $240,000. The fund will realize a nominal capital gain of $30,000, consisting of $20,000 in gain on stocks bought in 1980 and $10,000 in gain on stocks bought in 1982. When the cost of its assets is indexed, however, the fund will have no taxable gain or loss.

e. Assume the fund retains the entire $240,000. If an individual from Group A redeems his stock for $1,200 (net asset value of his stock), he will have a nominal gain of $200. Without indexing he would be taxed on this gain of $200, with no allowance for inflation. If he were allowed to index his $1,000 cost upward to $1,200 for the 20 percent inflation occurring between 1980 and 1984, he would have no taxable gain, just as if he had invested directly.

If an individual from Group B redeemed his stock on January 1, 1984, he would also receive $1,200, would have a cost without indexing of $1,100, and would have a taxable gain of $100. If, however, he were entitled to index his stock interest in the mutual fund, his cost would be adjusted upward from $1,100 to $1,200, and he would have no taxable gain, just as if he had invested directly.

f. Assume that instead of retaining its $30,000 nominal gain, the mutual fund distributed that amount to shareholders on January 1, 1984. Each of

the 200 shareholders would receive a distribution out of capital[1] of $150 ($30,000÷200). A shareholder in Group A would reduce his cost of $1,000 by the $150 distribution out of capital, leaving a remaining cost ($240,000—$30,000), and if the shareholder then redeemed his stock he would receive in redemption $1,050 ($210,000÷200). Without indexing he would thus have a taxable gain of $200 ($1,050 proceeds —$850 adjusted cost). If, however, he were allowed to index his stock in the mutual fund, he would first index his cost upward from $1,000 to $1,200; he would then reduce that amount by the $150 distribution out of capital, leaving him with a cost of $1,050, which is the amount he would receive on redemption. This would leave him with no taxable gain or loss, just as if he had invested directly.

If an individual in Group B redeemed his stock on January 1, 1984, and were not allowed to index, his cost of $1,100 would be reduced to $950 by the $150 distribution out of capital, and on the receipt of redemption proceeds of $1,050 he would have a taxable gain of $100. If, however, he were allowed to index his stock in the mutual fund, he would index his $1,100 cost upward to $1,200 because of the inflation occurring between January 1, 1982 and January 1, 1984; he would then reduce that adjusted cost to $1,050 by reason of the $150 distribution out of capital; and on the receipt of the redemption proceeds of $1,050 he would have no taxable gain or loss, just as if he had invested directly.

Thus, whether the individual invests originally upon organization of the corporation or invests at a later point after the corporate assets have fluctuated in value, the correct result is reached only if the individual is permitted to index his own investment in the mutual fund.

The only difference between the case of the original investor and those who purchase shares at a later time is that all shareholders of the company at the time of any distribution share in the distribution of capital gains on a share-for-share basis, even though some of the gains occurred prior to the time some of the investors entered the fund. Thus if the company distributes the $30,000 of nominal gain to all 200 shareholders, each will receive $150, although $10,000 of appreciation occurred during the time when only members of Group A were shareholders. This circumstance occurs quite generally in corporations, partnerships and other entities and is unavoidable, but works itself out in the end when the shareholder redeems his stock. It is only when the shareholder redeems his stock that the matter of indexing his stock interest becomes important, and at that time the proper answer is obtained only if his stock interest in the mutual fund is indexed.

2. As indicated in the principal memorandum, this matter of indexing the basis of an individual's interest is also involved with respect to other types of organizations, such as bank common trust funds, real estate investment trusts, etc.

The need to index the basis of an individual's interest in a real estate investment trust that owns only indexed assets would seem to be the same as in the case of a shareholder in a mutual fund that owns only common stocks. And the same need for indexing at the participant's level as well as at the entity level would seem to exist in the case of trusts participating in common trust funds, since the withdrawal by an individual trust from a common trust fund is taxed under Section 584(e) in a manner similar to the withdrawal by a shareholder in a mutual fund or a real estate investment trust.

A similar problem would exist with respect to partnerships. If individual A buys a parcel of real estate for $50,000, and after a lapse of 4 years, during which time the inflation index has risen 20 percent, he sells the real estate for $60,000, he will have no taxable gain under Section 404. Individual B could make a similar purchase and sale of real estate with no taxable gain. If in lieu of investing separately, A and B form a partnership, with each contributing $50,000,

[1] The Ways and Means Committee Report (p. 131) states "It is intended that the inflation adjustment also apply for purposes of computing the earnings and profits of any corporation. . . ." Thus, since mutual funds normally distribute currently all their earnings and profits, a distribution of the amount of the inflation adjustment would normally be a return of capital to the shareholders. In some instances over a period of time some mutual funds may accumulate some earnings and profits, usually because of a variety of minor matters; to the extent that the fund had accumulated earnings from prior years, the distribution of an amount equal to the inflation adjustment might technically be an ordinary dividend and not a capital gain dividend because it would not come out of capital gains of the corporation as calculated after application of indexing.

the partnership buys a parcel of real estate for $100,000, and the partnership sells the real estate after 4 years for $120,000, the partnership would have no taxable gain because it would be entitled to index its $100,000 basis by the 20 percent inflation factor to $120,000. However, when the partnership is dissolved and distributes its $120,000 of cash proceeds, each partner would receive $60,000 and have a basis for his partnership interest of $50,000; each partner then would realize a taxable gain of $10,000 under Code § 731(a)(1) unless each partner were allowed to index his $50,000 basis for his partnership interest.

Failure to permit a partner to index the cost of his interest, at least where the partnership owns only indexed assets, would create serious problems in partnership situations and would put intense pressure on the sometime doubtful decisions as to whether a group of investors constitute a partnership.

3. With respect to the matter of entities having a mixed group of assets, some of which are indexed assets and some of which are not, a somewhat comparable problem is dealt with in Section 854(b) of the Code with respect ot the eligibility of dividend payments from mutual funds for the $100 dividend received exclusion in the hands of their shareholders. This occurs because the mutual fund may have income from dividends received and also from interest received. The rule that has been in Section 854(b) of the Code since 1954 provides that if the dividends received by the mutual fund represent more than 100 percent of its gross income (excluding capital gains), then the entire amount of dividends received by the shareholders of the mutual fund will be eligible for the $100 dividend exclusion. If, however, the percentage falls below 75 percent, then the shareholder is entitled to the dividend exclusion only to the extent of that portion of the dividend received by him from the mutual fund as the aggregate dividends received by the mutual fund bears to the entire gross income of the mutual fund (excluding capital gains). This provision has worked without difficulty because the shareholder is bound by the notice of determination sent to him by the mutual fund (Section 854(b)(2)) and the mutual fund notifies the shareholder each year as to the amount of its dividend payments that are available for the exclusion.

The CHAIRMAN. Next, we will hear from Herbert B. Cohn, on behalf of the Committee for Capital Formation Through Dividend Reinvestment. He is accompanied by Mr. Samuel Cohn, vice president, Robert Nathan Associates.

STATEMENT OF HERBERT B. COHN, ESQ., ON BEHALF OF COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT; ACCOMPANIED BY SAMUEL M. COHN, VICE PRESIDENT, ROBERT R. NATHAN ASSOCIATES

Mr. HERBERT COHN. Thank you, Mr. Chairman. My name is Herbert B. Cohn. I am of counsel to the law firm of Morgan, Lewis & Bockius. I appear here this afternoon as Chairman of the Committee for Capital Formation Through Dividend Reinvestment.

With me, Mr. Chairman, as you have indicated, is Samuel M. Cohn who is vice president of the economic consulting firm of Robert R. Nathan Associates and who is a former Assistant Director of the Office of Management and Budget.

I might say parenthetically that Robert Nathan, chairman of the Nathan firm, wanted very much to be here and he asked that we convey his regrets. Unfortunately, he had a longstanding business engagement requiring him to be abroad all of this week.

I would like to request, Mr. Chairman, that my full statement be placed in the record and, according to the rules of the committee, I will present only a brief summary at this time.

The colloquy with Secretary Blumenthal at the hearing last Thursday and with some of the witnesses yesterday and this morning sug-

gests that your committee has a particular interest in cost-effective proposals for capital information.

We are here to urge a specific proposal which we believe can contribute immediately, directly and significantly, to capital formation where it is urgently needed and at a cost that is relatively nominal.

In essence, our proposal is to defer the current tax on dividends reinvested in original issue stock of any company having a qualified dividend reinvestment plan. The stock received on such reinvestment would instead be regarded for tax purposes as essentially the equivalent of a conventional stock dividend.

The substance of our proposal would be carried out by a bill introduced in the House by Congressman Pickle and 17 cosponsors. A similar bill, but with a cap of $1,500 per taxpayer per year, has been introduced by Senator Nelson and has been referred to this Committee.

A few months ago, our group retained Robert R. Nathan Associates to study the economic impact of this proposal as it then appeared in the Pickle bill. In extensive report, copies of which have been filed in the committee's office,[1] the Nathan firm concluded that adoption of the proposal:

First, would increase dividend reinvestment in new issue common stock by more than 500 percent, to some $6 billion.

Second, it would increase national output on the order of $10 billion annually.

Third, it would stimulate business fixed investment by close to $3.5 billion annually.

Fourth, it would add the equivalent of 200,000 jobs per year.

Fifth, it would involve a net revenue loss which, over a 3-year period, would be either nominal or nonexistent.

The Nathan report concludes, and I quote: "The Pickle bill, or legislation similar to it, certainly seems to be in the national interest."

Mr. Samuel Cohn is here to answer any questions relating to these conclusions, or to any other matters covered by his firm's report.

Adoption of the proposal would further important national policies in at least four respects.

First, it would provide substantial, direct, and immediate help in the formation of new common stock capital, to the extent, under the Pickle bill, of an additional $5 billion annually. Such capital formation would be taking place where it is urgently needed.

Senator NELSON. Mr. Chairman, if I may, I have to go to the floor to manage the CETA bill, but I have a question I wanted to ask.

The CHAIRMAN. Go ahead, Senator.

Senator NELSON. Your estimates on revenue losses differ, I believe, substantially from the staff of the joint committee. Do you have an explanation for that?

Mr. HERBERT COHN. Yes, sir, we do.

Senator NELSON. Is that one based on the Pickle bill with no cap, or the one that I introduced with the cap?

Mr. HERBERT COHN. The joint committee's staff proposal made some estimates that were based on the Pickle bill and some that were based on the Nelson bill, with a cap of $1,500.

Senator NELSON. How do you explain the differences in the revenue loss estimates?

[1] The report was made a part of the official committee file.

Mr. HERBERT COHN. With your permission and the chairman's, I would like to ask Mr. Samuel Cohn to address himself to that. He has worked on that extensively.

Mr. SAMUEL COHN. Senator Nelson, I would first like to preface my explanation with a statement that in my 30 years of public service, I have learned to respect greatly the professionalism of the great joint committee staff but, at the same time, I would like to say in this case I believe the staff estimate is a huge overestimate of the revenue loss that could be expected if this proposal were adopted.

There are a number of differences between their estimating assumptions and techniques and ours, but there are two of them that explain the bulk of the difference between their estimated revenue loss and ours.

First—this is not the larger of the two—we believe most economists would agree, and we heard about this from the witnesses this morning—that this draft proposal, if enacted, would stimulate private capital formation, overall economic activity, business, and personal incomes and would thereby raise income tax collections over what they would otherwise be. We call this tax recovery feedback.

The Joint Committee staff has not tried to forecast this feedback.

However, the committee staff did forecast a very large increase in the number of original issue dividend reinvestment plans and the participation in those plans in calculating revenue loss.

They forecast a much larger increase than we would expect as reasonable, and their estimate of the increase in plans and participation is the largest single difference between their estimate and ours.

For the Pickle bill itself, the staff forecast that participation in personal dividends reported in adjusted gross income that would participate in these plans would be something on the order of 36 percent and 60 percent.

A gross tax loss for a 60-percent participation according to their estimate is close to what I would believe is a reasonable estimate of all tax paid on all dividends reported in personal adjusted gross income. I think the staff itself would agree that it is at least 75 percent to 80 percent of all the income taxes paid on personal dividends that would be reported in adjusted gross income.

We believe these forecasts are wholly unrealistic. Our estimate is 20 percent of all such dividends. We characterize that estimate in our report as a surge in participation. It seems to me that the staff's estimate is a tidal wave. I think that it is very unrealistic to forecast a great deal more than six times the 3 percent that is now being reinvested in original issue plans.

We believe that these plans would be taken advantage of by many utilities and steel companies and others who have a great need for regular infusions of equity capital for investments in real plant and equipment.

But many industrial companies do not need, and cannot use, new common stock investment. They undertake investments in plant and equipment irregularly. They would not be interested in these plans.

Most of their investment funds come from retained earnings, depreciation allowances, investment tax credits and other internally generated sources.

In starting such a plan as an original issue plan and issuing new stock for these dividends, what would they do with the proceeds?

They would worry about the dilution of earnings per share and the downward effect on stock prices.

Now, the bill that Congressman Pickle reintroduced in the House in July—and I believe the same section is in your bill, S. 3430 that has the cap—will disqualify companies and individuals who, in effect, would not use this tax provision as a means of channeling funds into real plant and equipment investment.

To have a participation rate as high as 60 percent of all dividends of adjusted gross income, we believe, is completely unrealistic. Between that and the neglect of the feedback estimate, I think we have most of the difference between their estimate and ours, which is substantially smaller.

Senator NELSON. Thank you very much.

Mr. HERBERT COHN. I was saying that the adoption of the proposal that we are suggesting here this afternoon would further important national policies in at least four respects, one being capital formation.

The second is that it would represent a significant step in the direction of reducing the double tax on corporate dividends by eliminating the tax imposed at the stockholder level when the dividends are reinvested in the corporation.

Third, it would be more equitable in treating the receipt of stock under qualified dividend reinvestment plans as the equivalent of a conventional stock dividend. From the point of review of the stockholder who opts to take stock rather than cash, it really is the equivalent of a conventional stock dividend.

Fourth, it would assist and encourage stockholders in providing for supplemental retirement income. In this respect, it is analogous to the Keogh and the IRA programs which represent similar desirable national objectives and which have been encouraged by favorable tax treatment.

Accordingly, Mr. Chairman, we urge that the dividend reinvestment proposal, in the form of the Nelson bill or similar legislation, be included in the tax bill reported by this committee.

Thank you, sir.

The CHAIRMAN. Let me see if I understand your proposal.

When the corporation declares a dividend, it would declare it out of earnings and, of course, those earnings would have been taxed to the corporation. Is that correct?

Mr. HERBERT COHN. That is correct, sir.

The CHAIRMAN. So that the tax, you might say, would be deferred until such time as the shareholder should sell some of that stock. Would that be right?

Mr. HERBERT COHN. A tax would be payable when the shareholder sold the stock. Under the Nelson bill, it would be on a capital gains basis.

The CHAIRMAN. Yes, right.

Thank you very much. I think it is an appealing suggestion. If we can overcome the claim of the major loss of revenue to Government, maybe we can do something for you along this line. I find a lot of appeal to it.

Mr. HERBERT COHN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Cohn follows:]

STATEMENT OF HERBERT B. COHN ON BEHALF OF THE COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

My name is Herbert B. Cohn. I am of counsel to the law firm of Morgan, Lewis & Bockius in Washington, D.C. I appear here today on behalf of the Committee for Capital Formation Through Dividend Reinvestment. We have a specific proposal to present which we believe can contribute immediately and significantly to capital formation and to providing an important stimulus to construction of essential capital facilities, employment opportunities and a healthier economy. In essence, our proposal is to encourage increased reinvestment of dividends in new issue stock by deferring current taxes on dividends which are reinvested under qualified dividend reinvestment plans.[1]

Our Committee retained the firm of Robert R. Nathan Associates to carry out a study of the economic impact of this proposal. In its Report, the Nathan firm concluded that adoption of the proposal would:

1. Increase dividend reinvestment by more than 500 percent to some $6 billion;
2. Increase national output on the order of $10 billion annually;
3. Stimulate business-fixed investment by close to $3.5 billion annually; and
4. Add the equivalent of 200,000 jobs per year.

The Nathan firm estimates that on a "static basis," the revenue loss to the U.S. Treasury would be in the range of $300 to $400 million the first year; but that, after giving consideration to forecasted increases in both plans and participation, and to their economic effects, adoption of the proposal would result in a net revenue loss of something more than $1 billion in the first year, a wash in the second year, and a net revenue *gain* of $1.5 to $2 billion by the third and fourth years. The Report concludes that the proposal "certainly seems to be in the national interest."[2]

The members of our Committee consist of the 21 companies listed in Appendix A. These companies vary in size, geographical location, type of business and otherwise. They are, however, alike in the following respects:

First, they are capital-intensive and have a continual need to obtain additional common stock capital to finance their business.

Second, they find it more and more difficult and expensive to attract the necessary capital through large public offerings in the market place.

Third, each of them has adopted a dividend reinvestment plan under which its stockholders have the option of automatically investing any cash dividends declared by the company in additional new issue stock of the company.

Fourth, they have found that such plans have been a most effective vehicle for the formation of new capital and have provided significant assistance in obtaining required common stock capital.

Dividend reinvestment plans may be divided into two principal categories. The first—which are still the greatest in number—have as their primary objective providing a service to stockholders. This is done by pooling the dividends otherwise payable to the participating stockholders, purchasing the corporation's stock in the market place, and allocating the stock to the participants in the ratio of their reinvested dividends.

The second category applies the pool of reinvested dividends to purchase original issue stock from the corporation at prices related to then current market prices and generally without any brokerage or other acquisition costs to the participating stockholder. In these cases, the objective of the dividend reinvestment plan is not only to provide a service to stockholders but, more important, to use the plan as a means of obtaining additional common stock capital.

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[1] The essence of our proposal would be carried out by a bill originally filed on April 18, 1978, by Cong. J. J. Pickle as H.R. 12182, and subsequently refiled on May 31, 1978, as H.R. 12905 and on July 24, 1978, as H.R. 13581, with a total of 17 co-sponsors.

On August 18, 1978, Senator Nelson filed S. 3430, which is identical to H.R. 13581, except that it includes a limitation of the tax deferral in any one year to a maximum of $1,500 for a taxpayer filing a separate return and $3,000 for taxpayers filing a joint return.

[2] Fifty copies of the Nathan Report have been filed with the Staff Director of the Finance Committee.

The Report is addressed to a proposal, such as the Pickle bill, under which the tax benefits would be applicable without limitation on the amount per taxpayer. It states that if, as has been suggested, the proposed tax treatment were made applicable only to a specified amount per taxpayer, there would be a related reduction in all quantitative effects—i.e. in all costs and all benefits. (See Nathan Report, p. viii, n. 1.)

Our proposal relates only to this second category of dividend reinvestment plans for new issue stock. These plans have been adopted by companies generally having the characteristics of (1) being highly capital-intensive, (2) requiring periodic additions of new common stock capital to finance new capital facilities, and (3) having a need to maintain and enhance the declaration of cash dividends because their stock has been purchased on a yield basis and any action to reduce cash dividends would have disastrous effects on the market price.

There are now about 80 to 90 such plans with an estimated 1½ to 2 million participating stockholders. The large majority of participants are the smaller stockholders. The average holdings of the participating stockholders are less than the average of all stockholders and are generally in the range of 150 to 200 shares. It is estimated that in 1977 some $800 million to $1 billion was raised under these plans (or about 3 percent of total dividends received by individual income taxpayers).

Our proposal would defer current taxes on dividends reinvested in original issue stock of any company having a qualified dividend reinvestment plan. A qualified dividend reinvestment plan would be defined as a plan which did, in fact, provide for reinvestment of a cash dividend in new common stock capital.[3] The poses, as essentially the equivalent of a conventional stock dividend, which is, of course, not now subject to any current income tax.[4]

Under existing tax law, Federal income tax is imposed currently on the value of the stock received by a stockholder who opts to participate in a dividend reinvestment plan and to take stock instead of cash. It is clear that this discourages participation by those stockholders who may be pressed to use the cash dividends to pay the current tax. It is equally clear that deferral of the current tax would greatly encourage increased participation. The extent of such increased participation can, of course, only be a matter of opinion. But, as has been indicated, the Nathan Report estimates that adoption of our proposal, without limitation of the tax benefit per taxpayer, would increase the reinvestment of dividends into new issue common stock by more than 500 percent to some $6 billion.

Such increased participation would obviously be of major help in assisting capital-intensive companies to obtain essential common stock capital. It would provide an alternative (at least in part) for the periodic need to sell large blocks of additional common stock in the market place—with the associated market pressure which frequently leads to market prices at or below book value and continued dilution exerting further pressure to depress market prices. It would help larger numbers of stockholders, who do not at the time need the cash dividend, to participate in a simple, convenient and economical way to invest relatively small amounts which might otherwise be dissipated; and to obtain the advantages associated with a periodic savings plan, the principles of "dollar averaging" and the compounding effect to assist in building an investment which can provide larger cash dividends when the stockholder has need for such income.

From the broader perspective of the national interest—we believe that adoption of our proposal and the resulting increased participation in dividend reinvestment plans for new issue stock would further important and desirable national policies in at least four respects:

1. Capital Formation.—It would provide substantial, direct and immediate help in the formation of new capital—a highly desirable national objective. It is difficult to envisage any clearer or more direct way in which capital formation takes place than through a dividend reinvestment plan for new issue stock—where the reinvested dividends are immediately converted into new common stock capital. And, as has been indicated, such plans have their greatest appeal

[3] It has been suggested that a corporation having no need for new common stock capital might buy in its existing common stock and then adopt a dividend reinvestment plan for an equivalent amount. This would, of course, be contrary to the primary objective of our proposal; and we have proposed statutory provisions to prevent it. Such provisions would establish a presumption (rebuttable on a showing of a proper business purpose) that the tax benefit would not be available where a corporation purchased its own common stock within one year of the issuance of stock under a dividend reinvestment plan.

stock received on reinvestment of such dividend would be regarded, for tax pur-

[4] It has been suggested that our proposal could be circumvented by stockholders who, while not desiring to increase their investment in the corporation, would reinvest their dividends and then immediately sell an equivalent number of shares in the market place. To minimize any such motivation, we have proposed that (a) the basis of stock received under the dividend reinvestment plan would be zero and the holding period would commence on the date of its issuance, and (b) sales within one year after receipt of stock under a dividend reinvestment plan would be deemed to include the stock so received within the preceding year.

and, in general, have been adopted only by the most capital-intensive companies having the greatest need for new capital. Accordingly, under these plans, the capital formation is taking place where it is urgently needed.

2. *Eliminating or Reducing the Double Tax on Dividends.*—Elimination—in whole or in part—of the double tax on corporate dividends also has wide support as a desirable national objective. Our proposal would represent a step in this direction in eliminating the current tax imposed at the stockholder level when the dividends are reinvested in the corporation. There would appear to be particular logic for taking this step and eliminating the second tax under these circumstances—since the stockholder is not receiving the cash dividend and since the cash is, instead, being plowed back into the corporation where, if invested profitably, it could lead to additional taxable earnings at the corporate level.

3. *Fairness and Equity for the Participating Stockholder as Compared with the Recipient of the Conventional Stock Dividend.*—Many companies have the option available to reduce or eliminate cash dividends and declare alternative or supplemental stock dividends. In such cases, the recipient of the stock dividend pays no current tax. But companies whose stock has historically been purchased on a yield basis cannot, as a practical matter, reduce their cash dividend and substitute a conventional stock dividend. At the same time, there are many stockholders of such companies who, while they wish to remain as investors in such companies, would prefer, at least during certain periods in their working years, to take the equivalent of a stock dividend rather than cash. In the context of the practical realities, it would seem to be fairer and more equitable to permit the stockholder also to have their option and to treat his receipt of stock under a qualified dividend reinvestment plan for new issue stock as the equivalent, for tax purposes, of a conventional stock dividend.

4. *Encouraging Individual Savings to Provide Supplemental Income for Retirement.*—Many—and probably a large majority of participants in dividend reinvestment plans—have elected to participate during a period in which they do not require the cash dividends in order to be able to look forward to larger cash dividends at a later time when such income is needed as a supplement to social security and pension income. Our proposal would materially encourage thrift and assist participants in providing for supplemental retirement income. In this respect, the dividend reinvestment plan is analogous to the Keogh and IRA programs which represent similar desirable national objectives and which have been encouraged by similar favorable tax treatment.

In sum, our proposal would make a substantial contribution to a healthier economy; would further several important national objectives; and would do so with a net revenue loss which over a three-year period, would be either nominal or non-existent.

APPENDIX A

COMMITTEE FOR CAPITAL FORMATION THROUGH REINVESTED DIVIDENDS—PARTICIPATING COMPANIES

Allegheny Power System, American Electric Power Co., American Telephone & Telegraph Co., Baltimore Gas and Electric Co., The Brooklyn Union Gas Co., Columbus and Southern Ohio Electric Co., Dayton Power & Light Co., Delmarva Power & Light Co., Illinois Power Co., and Long Island Lighting Co.

Minnesota Power & Light Co., Montana Power Co., New England Gas and Electric System, Orange and Rockland Utilities, Inc., Pacific Power & Light Co., Potomac Electric Power Co., Public Service Company of Colorado, United States Steel Corp., Virginia Electric & Power Co., and Wisconsin Electric Power Co.

The CHAIRMAN. Next, we will hear from Mr. Leon Shull on behalf of Americans for Democratic Action.

STATEMENT OF LEON SHULL, ON BEHALF OF AMERICANS FOR DEMOCRATIC ACTION

Mr. SHULL. Thank you, Mr. Chairman.

I want to express my appreciation for having the opportunity to testify on this important matter. Unfortunately, I do not have a prepared statement, but with the chairman's permission, I would like to file one in the very near future.

I want to make some general comments about one section of the tax bill dealing with capital gains and also about some of the comments, I heard here for a couple of days now.

Talking about capital gains, I find it, Mr. Chairman, frankly a bit surprising to listen to the testimony given about the high rate of taxes on capital gains. My information is, as prepared by every expert group that I know of, including the joint committee and the Treasury Department, is that the effective capital gains tax rate is, in fact, somewhere between 16 and 19 percent. I find there is some disagreement as to how high it is or how low it is, but it is always within that range.

So when people come here and testify, witnesses come and testify about a 50-percent rate they are not really addressing the question of, what, in fact, is the effective rate for taxes on capital gains.

The second issue that I think is terribly important and no witness wants to seem to address it, is the one raised by Senator Danforth this morning. That is the fairness question, or the equity question. I think that cannot be ignored in any approach to the tax bill.

I think that a lot of the problems with tax bills around the country today arise from the fact that many of the taxpayers feel that the tax code is, in fact, unfair and I think a part of that unfairness is when different forms of income are taxed differently.

I am aware that there are social purposes attached to different forms of taxes, different rates of taxes on income and on different types of income, but I think that we ought to, as a country, ought to be careful all the time to address the issue of fairness.

Also, every study that I have read makes it quite clear that those with the most money—and I hope I will not be accused of attacking the rich: that is not what I am here for—but just the studies I have read tell me this, and they are done by impartial groups, including the Treasury Department, whether it is under Republican or Democrats, under conservatives or liberals, that the higher the income, the lower is the effective tax rate on capital gains.

It is not the little fellow who manages to get away with paying low-income rates. It is the large investor who seems to be able to do that.

I would also say—I can also offer the example of foreign countries in the area of taxation. I think people tend to choose examples which buttress their own cases, but the same examples often work both ways.

If one were to take the tax system of Germany and apply it to this country, I think that the people who are making the point that there are not any capital gains taxes in Germany would not be so happy. A much larger percentage of their gross national product is taken in taxes by their government than is true in this country.

One may offer that as an example of making a healthy economy. That was not offered as an example today, and I know there are other examples running in other direction.

I think the House bill and the Senate bill that matchs it are really basically unfair on capital gains. I have looked at the table and the estimates prepared by the Joint Committee on Taxation. I find that on the House bill, that out of the 327,000 individuals who would get a tax decrease under that bill, 188,000 of them earn $50,000 or more. So that, in fact, as I read it from the Joint Committee on Taxation table, 93.2 percent of all the benefits under that tax bill will go to those who earn $50,000 or more.

I would like to commend to the Finance Committee the new bill that was introduced by Senator Nelson, S. 3410. I really think it is a better piece of legislation. I think it is more equitable than the House bill or its companion Senate bill and would result in a better tax legislation for the country.

The reason I say this is that the Nelson proposal is a simpler proposal. The Nelson bill will not change the present tax rates, it will not change the present exclusion provisions, it will not change the minimum or maximum tax provision. What it does do, is exclude the first $1,500 of income from taxation on capital gains and, for a married couple, would exclude the first $3,000 of capital gain income.

If one looks at what the Joint Committee on Taxation says about the Nelson bill and what the result would be, they are really quite dramatic, because what it does is shift the tax relief to that place where I think it is actually needed.

I think it is easy to make the case that those taxpayers in this country that need relief most are the $20,000 to $50,000 bracket. They are the people that are complaining they are carrying a heavy load.

While the House bill and its companion Senate bill would transfer approximately 14 percent of the tax relief to people in the $20,000 to $50,000 bracket, the Nelson bill would transfer 49.4 percent of the tax relief to people in the $20,000 to $50,000 bracket. I would submit, just on the basis of fairness, equity, and giving the most relief where it seems to me it is really needed that the Nelson bill, therefore, is, in fact, superior to the House bill; would accomplish approximately the same purposes; and would not seem so inequitable and unfair to the taxpayers of the country.

I would just conclude my testimony on this by reiterating that under the Nelson bill, 49 percent of the benefits would go to the $20,000 to $50,000 taxpayer bracket while under the House bill, 93 percent would go to those who would earn over $50,000; 74 percent of the benefits in the House bill would go to those who earn over $100,000.

I really do not think that the House bill gives us a fair and equitable bill. I think that the Nelson bill does, in fact, do that.

I might also point out that if we are taking about capital formation that you would hit a much larger group of taxpayers under the Nelson bill making funds available for investment than you do under the House bill.

Under present-day circumstances you could argue that if Congress were to adopt the Nelson bill, that we have not created a relief bill for the rich. What we would have in the Nelson proposal is a relief bill for the middle-class taxpayer. I would hope that is the direction in which the Finance Committee would go.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me direct your attention to a new publication I know you are going to spend some time studying it, because it would certainly have a lot of information important to you and important to our committee. This is the recent report, "High Income Tax Returns, 1975 and 1976," a report emphasizing nontaxable and nearly nontaxable income tax returns, and it is put out by the Office of Tax Analysis, Department of the Treasury, August 1978.

Have you read that report?

Mr. SHULL. I have not seen it.

The CHAIRMAN. I think you will find it very useful because in many cases it will serve your purposes; in some cases, it will not.

If you look at table 15 which is on page 40, you will see there is an analysis of how much we think taxpayers who make $200,000 of income are paying; taking all things into consideration, we are very much aware of the fact that of that group, there are about 5 percent that are getting by with paying next to nothing, that is, less than 5 percent of their income in taxes. And we want to do something about that—and even about those who are paying less than 15 percent.

As is pointed out, 75 percent of those taxpayers are paying over 25 percent of their income in taxes, and I am not concerned about somebody paying 25 percent. Here are the averages on table 15.

We on this committee would like to see how these tax returns are analyzed. Senator Haskell wanted them studied in one way, based on expanded income, and I want it studied on the basis of adjusted gross income plus preferences, or adjusted gross income less interest investment—I cannot recall exactly which of those two I wanted at the time. I would like to have it analyzed all four ways. That way you can pay your money and take your choice, which one you would think is most fair.

No matter which concept you use, those people in that bracket are paying on a basis of standard income, 30.2 percent; 36.5 percent on the basis of adjusted gross income; based on preferences, 34.2 percent; on the basis of adjusted gross income less investment interest, they are paying 36.9 percent.

Now, if you take out the 25 percent of those people who, from my point of view, we ought to be targeting for further taxation because they are getting by without paying their share, and then look at the 75 percent, those people have to be paying well over 40 percent of their income in taxes. At least as far as the 75 percent are concerned, pay a lesser rate than middle-income or lower-income taxpayers.

I would be the first to agree that people who are getting by paying next to nothing ought to be taxed. I am not going to say people are getting by paying nothing. I used to say that. But if you analyze what is in this booklet, I do not think, of those 22 returns where they found they are paying nothing, that they should be paying tax. When you analyze it you find out that they had a high casualty loss, they paid a large amount of taxes to a foreign government on income there, or they had some other major expense which, from my point of view—and I believe from Mr. Lubick's point of view over in Treasury, and I think he agrees with you on a lot of this—would be people who paid no income tax because by consideration of justice and equity they owe none.

But in regards to the 75 percent of those who are making that much money, they are really paying us, I believe, a fair amount of taxes.

In other words, that 30 percent you are looking at, if you adjust that to take into account the ones that we are going to make an effort to tax more heavily with a minimum tax and things of that sort, I would think that you would have to say the other 75 percent are paying their share.

Do you think that, let's say, 43 or 44 percent is too little to tax those people?

Mr. SHULL. Well, Mr. Chairman——

The CHAIRMAN. I mean, on the overall.

Mr. SHULL. Sure, When I made my comment before, I was talking to the question of capital gains taxes, and what I meant was that I thought and I believe that I am going to go through this—I appreciate your giving me this book and I am going to go through it carefully.

The CHAIRMAN. It's a very useful volume. Don't lose it.

Mr. SHULL. I don't doubt it and I thank you for it.

I was really talking about capital gains taxes, but I guess where one thinks the tax level should fall is really a matter of opinion and values, and one person's is as good as another's, and I am not going to set mine up as better than yours or someone else's. I don't have a right to do that. I would point out to you, sir, though, that I don't have an income anything like $200,000; I wouldn't mind having it, but I don't. I pay——

The CHAIRMAN. I don't see that that makes any difference. I mean, you could——

Mr. SHULL. I pay the tax rate.

The CHAIRMAN. Pardon me?

Mr. SHULL. I pay the tax rate and higher, and yet I live—well, I don't——

The CHAIRMAN. Are you paying that much on your overall income, I mean, on all of it?

Mr. SHULL. I don't have any tax expenditures—I am not a welfare case but the point I am making is that I live on a salary. That is my income. I am not complaining about that. What I am saying is, though, that I pay the full rate. They take it out of my wage check every week, and it does seem to me that while it is legal and not immoral for people to take advantage of every tax expenditure that they have because of losses and breaks or foreign taxes or what have you, it does seem to me that most people in this country would think it is unfair.

I am not accusing everyone of doing that, but some legally wind up paying a very low tax rate. And I think that the 30-percent tax rate for people that earn $200,000 and over is a fairly low tax rate.

The CHAIRMAN. We are not talking about rate. We are talking about a percentage of what they pay. Those people are paying at a 70-percent bracket.

Mr. SHULL. Yes.

The CHAIRMAN. They are paying at a 70-percent rate, but that is off the top.

Mr. SHULL. Well, frankly, I cannot translate that figure into the 70-percent bracket here.

The CHAIRMAN. Let me just put this to you to help explain the problem.

You perhaps heard me in this morning's session make reference to a chief executive officer who I said I think is one of the ablest chief executive officers in America, and he is highly respected by others who occupy similar capacities. He is doing a great job for his company. He does not invest his money in that company. He takes his money and puts it into land, into real estate. Now, why does he do that? Because if he earns income by way of his company, that income is going to be taxed first at 48 percent, and what is left will be taxed at 70 percent, and by the time he gets through with all of that, out of every

dollar of company earnings, he will make about 16 cents, if the corporation declares it all out in dividends—and par for the course for that size corporation is to declare about half of it in dividends.

That means that he would get, out of every dollar of earnings, 8 cents after Federal taxes, and when he looks at all of that, doing the best he can for his company, he concludes that he could do a lot better with his money by putting it into just raw land, just some land out there that doesn't even have a cow on it, just some weeds growing on it or some old scrub trees. Looking for something to appreciate in value, he would be better off with that land, or he would be better off putting his money in a tax-exempt bond.

Now, in either event, he is not going to pay us any tax on that right away. In one case he never does pay a tax. In the other case he would pay us a tax only when he sells it and that would be a capital gain. If he doesn't have to sell, he might never sell it, and may pass it on to his children.

Now, can you really blame anybody for simply doing business the way it makes the best sense, on the theory that he is in business to make money?

Mr. Shull. No; I wouldn't blame anybody for doing it, but perhaps we shouldn't skew our tax system so that it pays him to do that. I think your manager, your businessman manager perhaps puts it into the land because he does—I'm sure he puts it in because he gets a good return, but isn't one of the reasons he makes out well with it is because he will wind up paying a much lower tax rate there than he does as your own example, of course, showed, 48 percent on the corporation tax, and then finally he pays his own tax.

So perhaps part of the problem there is that we make it desirable, purposefully, of course, to invest there. So he puts his money there.

If we didn't make it that easy, perhaps he would invest in his own corporation. Maybe that would be better for the country, maybe better for the corporation. He might make somewhat less money, but we are talking about social policy.

The Chairman. I have heard the argument made for the other side, and I want to go back and check with some of those people who have made that argument down through the years and see if they still feel that way. Basically it is an argument that you ought to tax the eyeballs off that man no matter where he turns, and that is something you are not going to do. For example, you can't get the votes, try as you may, to tax these State and municipal bonds. You can't get the votes to do that.

Sometime back I thought it might be a good idea to have a withholding tax on interest and dividends, so I joined forces with those who would like to do that, and we took the bankers by surprise. We didn't give them any notice. We just offered it out there on the floor and voted on it as soon as we could, but we couldn't bring it to a vote the same day we offered the amendment, so between the time we offered that amendment and the time we voted on it the next morning, all those bankers got a chance to get on the telephone and talk to their Senators, and the result was that we lost that by a very substantial vote.

You are not going to put some of your ideas into effect about taxing everything, even though you might like to, and that being the case, it seems to me that we had better be recognizing reality and thinking in terms of trying to make it sufficiently attractive, for example, for that

man to invest his money in his own business. Now, that is the kind of thing the previous witness was testifying for, and I know you disagree with that, don't you?

Mr. SHULL. Yes.

Senator, you are 1,000 percent right—maybe that's the wrong term. You were 1,000 percent right in your desire to tax dividends at source, or withhold them at source, and interest. I have never understood the morality or the ethics of being opposed to that. It seems to me that it is just the people—well, I have no right to impute motives to them, but I sort of wonder why, why shouldn't they? That money is supposed to be taxed and they can certainly get it back—Uncle Sam is awful good at sending checks back when you overpay, and I have never understood that. So you were absolutely right and I hope you will take up that battle again some day.

But one of the reasons I came here to urge serious consideration of the Nelson bill was because I recognize the reality that there is going to be a cut in the capital gains tax. I do recognize that, Senator, and I don't believe in standing in the way of the tide. What I was urging is that if there is going to be a capital gains tax, couldn't we at least push it in the direction of helping more people, smaller taxpayers—Senator Nelson's bill would help everyone—I have seen the figures prepared by the Joint Committee, it does help in every tax bracket, but I am impressed with the fact that it helps this enormous number of people in the $20,000 to $50,000 bracket. It makes the money available for capital formation, if that is the prime aim of this—and that is what I am always being told, that that is in fact the prime aim. Nobody wants to get more money in their own pockets, they just want to form capital for the good of the country. Well, that would form capital for the good of the country, and at the same time make people feel it is fairer and more equitable, and that is the group of people who are earning in that bracket—and who feel pressed. This would make some money available to them. I was impressed with the statistics I saw from the New York Stock Exchange showing how many people—are small holders and don't have a lot of money and are investing there. And I would like to see that if we are going to do this—and I think, and I know that Congress is going to do it—I would hope that they would be prepared to say, well, let's give it to the small investor.

Let's give him a break on his income taxes. Let's encourage him to do the investing rather than the very large investor whom I don't know needs such enormous encouragement. I think they are going to be there investing because they have got the money to invest, and they are going to invest it.

The CHAIRMAN. Well, you have made a good argument, Mr. Shull, and I thank you for your testimony.

Mr. SHULL. Thank you, Mr. Chairman.

The CHAIRMAN. Next we will call Mr. Robert E. Juliano, legislative representative of the Hotel and Restaurant Employees and Bartenders International Union.

Mr. Juliano, I am very happy to see you before our committee today because down through the years it has been my pleasure to support the restaurant employees and hotel employees and the bartenders. I have some good friends who are bartenders.

Mr. JULIANO. Thank you. We appreciate your business.

The CHAIRMAN. And if you have an updated list of the bartenders of Louisiana, I would like to have it. They are good people to communicate with.

Mr. JULIANO. I certainly do.

Senator, thank you. I ask first that the full statement be included in the record, and the attachment.

The CHAIRMAN. By all means.

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL AND RESTAURANT EMPLOYEES AND BARTENDERS INTERNATIONAL UNION

Mr. JULIANO. Mr. Chairman and members of the committee, I appreciate the opportunity you have given me to appear on behalf of our general president, Ed Hanley, and all of the members of the Hotel and Restaurant Employees and Bartenders International Union to testify with respect to the Revenue Act of 1978, H.R. 13511.

Those of us who represent workers have for some time been urging the enactment of appropriate tax reductions to stimulate employment. We have believed that this would, in some measure, protect against inflation, against further erosion of permanent jobs, and indeed, create new private sector jobs which are sorely needed. To the extent that the tax program you are considering achieves that goal, we wholeheartedly support it. But this aspect of the legislation which is vitally needed had been totally overshadowed, until recently, I might add, by the conscious, deliberate injection into the debate of a political issue regarding what the President's men like to call the three-martini lunch. Indeed, their choice of such code words as the three-martini lunch is intended to shroud the real issue; namely, jobs.

Mr. Chairman, the House Ways and Means Committee deliberated this bill for many months. Although the issues impacting my members most severaly had the highest media visibility, every amendment that was introduced in an attempt to limit deductions for legitimate business related entertainment expenses was categorically rejected by the committee. It was our feeling that the committee understood the true issue involved here; namely, jobs. If such amendments had passed, the impact on our international union and the industry in general would be enormously negative and have a profound affect on employment and our overall economy. In fact, we believe and hope that our testimony presented before your distinguished committee will support contentions that those issues with the highest amount of media visibility in fact have the least amount of substance and will be categorically rejected by your committee if in fact the subject is even raised.

Just recently our union was privileged to testify before Senator Byrd's Subcommittee on Taxation and Debt Management on the charge tips issue. We testified, together with management, in support of S. 1674, a bill which would repeal two IRS revenue rulings that would have a negative impact on gratuity employees. In 1976 your committee wisely adopted a clarifying amendment which revoked Revenue Ruling 76-231. Since the ruling came after the House had reported out a tax bill and therefore could not consider this issue, when the Senate and House conferees deliberated, a moratorium was

agreed upon nullifying the IRS ruling until January 1 of 1979. Since a bill is now pending before your committee which does the same thing you adopted 2 years ago, we would appreciate your considering this measure as part of your overall bill. The House has the exact same piece of legislation and intends to take it up in their phase II tax hearings.

Since the IRS has presented to this date no new facts or any facts to support their position, we urge this committee to favorably consider S. 1674, which basically maintains the law that has been in existence since 1965. This situation presents a classic example where an agency of the executive branch has tried to circumvent the legislative by issuing administrative rulings intended to set aside legislation already in existence and already working.

One prominent columnist, when the issue of the business lunch and dinners was first raised, Mr. Chairman, supported the administration's proposal to repeal the business meal deduction. But once he began to understand the job implications of such action, he became much more reflective. As George Will said, "It is politically difficult and morally questionable to reform laws, rules, incentives, and disincentives to which powerful interests and vulnerable lives have conformed, and on which they depend. A large State is rendered conservative in the sense that it must face that fact that society is not a Tinkertoy that can be tinkered with casually."

Society is not a Tinkertoy. And the lives of my members should not be played with for political motivation.

If there is even a 5-percent reduction in expenditures in the hotel and restaurant field, I am advised by our economists—and part of what we submitted is an economic study, Mr. Chairman—that the job loss in those establishments alone will amount to 135,000 people, many if not most of whom are my members. And the study goes on to address the study done by the Congressional Research Service, which was a theoretical study which really I think our studies effectively refute.

Thank you.

If you have any questions——

The CHAIRMAN. Now, we are scheduled to hear also from Mr. Neville. Is he here with you?

Mr. JULIANO. Mr. Neville is here, and Mr. McDermott.

The CHAIRMAN. Do you have a prepared statement, Mr. Neville?

Mr. NEVILLE. I beg your pardon.

The CHAIRMAN. I would prefer to hear all three of you first.

Do you have a prepared statement?

Mr. NEVILLE. Yes, I have.

The CHAIRMAN. Just go ahead, if you would.

I'll ask my questions after you have made your statement.

STATEMENT OF ROBERT NEVILLE, WASHINGTON COUNSEL, NATIONAL RESTAURANT ASSOCIATION; ACCOMPANIED BY DOUGLAS BENNETT, SPECIAL TAX COUNSEL

Mr. NEVILLE. All right, sir.

Mr. Chairman, we appreciate the opportunity to present the views of our association whose members, ranging from thousands of individual entrepreneurs to the major corporations in the hospitality in-

dustry, are engaged in all types of food service in every State of the Union.

With one exception we have confined our testimony to those provisions of the revenue bill of 1978, H.R. 13511, which we believe will have the most direct effect upon the economic health and continued solid growth of the food service industry. A proposal made earlier this year by the administration to place extensive limitations on the deductibility of business promotion meals was considered and overwhelmingly rejected by the House Ways and Means Committee and is not mentioned in H.R. 13511. If enacted, this proposal would have such adverse effects on employment, revenues, and the economic viability of a major segment of our industry that we believe your committee should be made aware of those effects.

The business promotion meal is an ordinary and necessary cost of doing business, just as other promotional business activities are. Small businesses would be adversely affected relative to larger established companies as it is often the only practical, affordable form of promotion available to them. Sales and economic health of some 260,000 restaurants employing 3 million people would be harshly affected, according to the U.S. Treasury, by a sales decline of $1 billion and a job loss of 50,000 to 70,000 people. These are Treasury estimates. Our estimates are slightly higher. Most vulnerable to this job loss are women, teenagers, blacks and other minorities. We estimate a loss of Federal and State tax revenues of $144 million and increased unemployment compensation costs amounting to $70 million or more.

We have provided a more complete discussion of these effects Mr. Chairman, for the committee in our prepared statement which we ask be included in the record.

The CHAIRMAN. Certainly.

Mr. NEVILLE. I would also like to mention, as Mr. Juliano has, that earlier this month we testified before Senator Byrd's Subcommittee on Taxation and Debt Management in support of S. 1674, co-sponsored by Senators Laxalt, Cannon, Curtis and Dole, relating to recordkeeping and reporting of charged tips. We trust that the Finance Committee will again, as it did in 1976, favorably report this measure as part of the tax bill presently before you.

We applaud and strongly support the restructuring of the corporate income tax schedule by graduating the rates through two new tax brackets and reducing the marginal rates of the present law. We believe this change will be particularly helpful in establishing and maintaining the economic health of small businesses in our industry. The much less precipitous rise in the tax rate will encourage the kind of risk taking that is essential to economic development and the creation of jobs.

We feel also that the graduated rates will provide much more flexibility to small business owners in deciding the form of business organization most suitable to their enterprise.

We support the Hosue decision to make permanent the 10 percent investment tax credit and to extend its use to 90 percent of the tax liability. Extension of the credit to rehabilitation of commercial as well as industrial structures is a step in the right direction which we heartily support. We have supported and continue to urge that it also apply to the construction of new commercial and industrial structures.

Our industry, composed primarily of small businessmen, competes at a comparative disadvantage for capital, most of which is designated for construction purposes. Retail establishments in our industry create more jobs per dollar invested than most industrial enterprises.

We view the changes made in the taxation of capital gains by H.R. 13511 as particularly beneficial to persons owning small business enterprises, and as a necessary step in encouraging the creation of the capital essential for economic growth. In our view, the present law does not encourage the acceptance of risk essential to capital formation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

I believe Mr. McDermott is next.

STATEMENT OF ALBERT L. McDERMOTT, WASHINGTON REPRESENTATIVE, AMERICAN HOTEL AND MOTEL ASSOCIATION

Mr. McDERMOTT. Mr. Chairman, my name is Albert L. McDermott, Washington representative of the American Hotel and Motel Association. The association is a federation of hotel and motel associations located in the 50 States, representing approximately 7,000 hotels and motels which include most of the major chains and independent properties. The total of employees directly employed in our industry is approximately 860,000 employees. We have submitted a comprehensive statement, and we ask that it may be made a part of the record.

We would like to address one particular area that is of great concern to the hospitality industry, the administration's desire to limit tax deductions on business meals and entertainment. Although we realize that the administration has limited its proposals somewhat since the announcement of President Carter's original proposal, there are still continuing references to restricting the tax deductibility of legitimate deductions such as business meals and business use of country clubs, tickets, theaters, and sporting events and deductions for boats. The administration's original business expense proposals which Secretary Blumenthal said before your committee are still "in accord with sound principles of tax policy," go to the very heart of the hospitality industry's business. It is critical that your committee clearly understands the harm this philosophy could have on our industry, our employees and the national economy, if enacted into law.

We recently commissioned a study, the first phase of which is being made available to you, to determine the effect the proposals to curtail tax deductions for business expenses would have on our industry. That study, which was conducted by two national independent certified public accounting firms, concluded that the administration's original proposal would cause a loss of $1.9 billion of hotel-motel revenues annually, and approximately 60,000 to 90,000 jobs in our industry, and 20,000 to 30,000 jobs in those industries that provide us goods and services. These are lost jobs, not jobs affected, not hours lessened, more days off, and so forth.

The hotels and motels hardest hit would be those of over 100 rooms. These hotels-motels generate approximately 68 percent of total receipts and 66 percent of total industry employment. Nowhere in the Treasury's detailed descriptions or House and Senate testimony is there analysis of noncompliance with present law. In fact, the IRS is

not even asking for information on corporate entertainment, travel, and business gifts until the filing of calendar year 1978 tax returns. There is just a vague and unsupported assertion that the Administration perceives this part of the tax law to be unfair and unnecessary as it provides personal benefits and personal enjoyment to the recipient.

A personal enjoyment rule introduces an entirely subjective element into tax policy and makes the Federal Government the arbiter of what constitutes personal enjoyment and how much it is derived from various types of business activities. Such a personal enjoyment standard has no place in determining whether an item is a legitimate business expense deduction. We believe that all allowable business expenses reasonable in amount and properly documented should be deductible.

Mr. Chairman, in the interest of time, I am going to postpone any further reading of my testimony and urge that you reject any proposal which would disallow bona fide, substantiated business expenses which would result in substantial lost business to our industry and cost many of our employees their jobs.

Thank you, Mr. Chairman.

STATEMENT OF THOMAS W. POWER, GENERAL COUNSEL, THE FOODSERVICE AND LODGING INSTITUTE

Mr. POWER. Mr. Chairman, my name is Thomas W. Power and I am counsel for the Foodservice and Lodging Institute. The Foodservice and Lodging Institute is an association of 35 of the largest hotel, motel, restaurant, and foodservice companies in the country, mostly multiunit, multistate organizations that collectively have sales in excess of $15 billion a year and employ over 2 million workers. I have filed a complete statement on the tax reform act and I would just like to make a few comments.

First, I would like to endorse Mr. Juliano's and Mr. Neville's recommendation that the committee consider favorably S. 1674, having to do with charged tips. I don't think anyone realizes the full impact that requiring employers to report to IRS charged tips will have as far as the bookkeeping burdens on our industry. At the present time, when a tip is charged on an American Express card or a Bankamericard or what have you, generally the employee brings that charge to the cashier and is paid out the tip that appears on the charge, maybe $1.50 or $2.00 or whatever it amounts to.

Under this proposal that IRS will adopt effective January 1, the employer will be required to record on the charge slip the name of each employee and the amount of the tip paid out on each transaction. This amounts to literally billions of transactions in the course of a year. It will affect perhaps 2 million employees who will be required to coordinate all of those records. Perhaps the tips will be paid out by two or three different cashiers from different cash registers in the same establishment. The employer will be required to record those tips paid for the period of an entire year. The most disheartening thing about it, Senator, is the fact that we do not believe that it will facilitate the collection of more taxes by IRS in any way, shape, or form. Basically, the tips, the charged tips that we would have to record and report to IRS as being paid out to an employee, do not, in fact, reflect the real income of the employee who receives the charged tips, because the

employee typically splits those tips with another employee. We have no accounting or record of the amount of tips that are split by the employee with perhaps the busboy or bartender, which generally amounts to 15 to 25 percent of the charged tip. In addition, there is no way to segregate that charged tip from the cash tips that are typically recorded along with charge tips to the employee. Under this new proposal, we now have to get two reports from an employee, the amount of charged tips that he has received and the amount of cash tips that he has received, and the burdens are astronomical on our industry, from our vantage point, and we do not see any way that the IRS can effectively make use of the information. We also are convinced that the information for the proper collection of taxes by IRS is already available to them. What they are going to do is mandate millions of dollars worth of recordkeeping that will facilitate the collection of a de minimus amount.

So we would urge the committee give favorable consideration, and I am sure the committee is aware already that there is substantial support for an amendment on the House side, and we believe that it would be adopted in conference. And I need not comment, we obviously oppose the President's recommendation in connection with the deductibility of business meals.

The CHAIRMAN. Well, let me say this, gentlemen. I am on your side, particularly I am on your side with regard to the right of a person to deduct entertainment expenses in the line of his business.

Now it may be that the majority of people have been convinced that a salesman shouldn't be able to deduct the expenses of taking somebody out to lunch or to dinner, but there are things about that that don't meet the eye. Just for example in New Orleans, Louisiana, where I have lived for quite a period of time in my life, they have a lot of restaurants, and there are a lot of good ones. Well, now, if you go there at the time of the Sugar Bowl or you go there at Mardi Gras time or you go there at the time of the Superbowl Game, you will be standing in line to get in one, but the chances are you can manage to get in one of those famous restaurants down there and be served. There is no way they could keep enough restaurants in business to serve the crowd when all the crowd wants to come to New Orleans on just a day day in and day out business unless they have some regular customers. You can't keep those restaurants open just for the Sugar Bowl game and for the Mardi Gras day or something of that sort. You have got to have some day in and day out business.

Isn't that right, Mr. Juliano?

Mr. JULIANO. Yes; it is.

Earlier today, Mr. Chairman, I think it was Senator Curtis who mentioned that, in your deliberations in your overall bill, you were concerned about capital formation and about the percentage of the total economy decreasing as it relates to manufacturing, and I think you mentioned it went from a third to a quarter, but we all have been trying to tell the Government this—you know where that other part is increasing, and it is increasing in the service sector, and it is increasing in our business. And instead of sitting down with us, which we have urged them to do, and saying let us find out more about our business which employs 4½ million people and contributes $115 billion to the economy, they keep coming up with these hairbrained schemes that are

trying to knock and dislocate people out of work. And they have no idea, really, of the type of impact. And all that keeps happening, as you suggest, is the industry keeps getting larger.

The CHAIRMAN. If we did what the administration is recommending, we would put just lots of nice restaurants out of business. The McDonalds could stay open, and I like McDonalds, I like the Burger King and I like the Taco Bell, but it would be nice if every city had at least one nice restaurant where you could take papa or grandmama out for their anniversary or for special occasions. Many cities are not going to have any nice restaurant if that provision goes through where you make it so that a salesman can't take people out day in and day out and entertain them.

Mr. JULIANO. In the Congressional Research study, which was done at the request of Senator Kennedy, part of what they failed to take into account was just what you mentioned, Mr. Chairman. That is, they contend that there wouldn't be any loss of employment. The study took a case of microeconomics and applied a macroeconomic theory because I think most anyone, proponents or opponents, would agree with us that you are not going to find much entertainment being charged at a McDonalds or Burger King or so on. They fail to take into account that our areas, hotels and tabletop restaurants, would be the ones most drastically affected, and we have the highest degree of full time, permanent jobs that would be lost forever.

The CHAIRMAN. Let me just tell you this, gentlemen. If you lose on this issue—and it is possible that you will lose it—but if you lose, it will be all your fault because you people should go into 100 Senators' offices, and you should explain your case to 100 Senators, and also you get some constituents from every community to go talk to those Senators. There is going to be a recess and they are going to go home over the recess, and if you have a delegation to meet them when they get home, at their home town, or the principal city in their State, if your people just get busy and ask for a meeting and turn to, you will make your point. I can recall how it was when I had some doubts about that issue some years ago, and all the nicest restaurants in Louisiana came up and called on me, and I recognized all these people. Here they were from the best restaurants in Shreveport, Baton Rouge, Monroe, Lake Charles, Lafayette, New Orleans. When I took a look at all that crowd, school was out. I knew how I was going to vote right then and there. I didn't even have to hear the arguments.

At the time you see all your favorite restaurant keepers show up on the scene, and then they explain their problem and show how it is going to wreck their business, there's not many of these Senators are going to turn them down. But your people are going to have to work at this thing, to be on the safe side.

Have you been knocking on the doors and talking to all these people?

Mr. JULIANO. Yes.

Mr. POWER. Senator, you may recall, I was with the Louisiana restaurant people when we came to visit you the last time around.

The CHAIRMAN. Right.

Your people will have to get busy. It is a challenge, and they can't win it by just sitting on their back sides. They don't necessarily need to come to Washington, but if they don't, they ought to contact their Senators when they go to their home Sates over this recess.

Mr. McDermott. Senator, may I just add one thing for the record?

The Chairman. Yes.

Mr. McDermott. We are doing what you suggest and will continue to do it. The American Hotel and Motel Association did appear before Senator Byrd's subcommittee on "charged tips," and I simply want to be recorded as saying that we favor existing law and trust that the committee will favorably report the terms of S. 1674 on "charged tips."

Mr. Juliano. Well, I think, Mr. Chairman, that we were—I was here, anyway, when Secretary Blumenthal testified, and I wouldn't want to be accused of reading something into their mind, but I didn't sense the kind of fervor existing in the administration that existed 6 or 8 months ago. However, we will take your words to heed and continue to push on the issue as strongly as we have in the past.

The Chairman. Well, if they think they have got a chance, they'll probably have the President on the telephone calling everybody, so——

Mr. Juliano. I am sure.

The Chairman. So what you people had better do is to get busy and get all those local restaurant people to talk to their Senators so that Treasury will find that they are so far behind that there is no point in importuning the President to bother himself doing something like that.

Mr. McDermott. Thank you for your wisdom.

The Chairman. He'll find other things that are more important to work on, because the best way to win a fight is to get far enough ahead that people are not going to want to go any further with the matter.

Now, I think you are right about this. I would hate to see many of the nicest restaurants go out of business. These are the places where you can take someone, be it your wife or some dear relative out to enjoy an anniversary party or to celebrate their birthday or something of that sort. I would hate to find all those nice places gone, or most of them, just because somebody was derelict; and your people are the ones who ought to work the hardest at it. I think there are a lot of people who don't realize that they have a stake in what is involved here.

Let's just take the relatively small cities with only one nice restaurant in town. If most people thought that their Senator voting to tax the so-called three-martini lunches meant that they were not going to have a single nice restaurant in town, they wouldn't tell us to vote that way. But I suspect that most folks don't understand that this is going to cost them either the only nice place they have in town, or probably half of the nice places they have in their home town. If they understand that this is what it means, I don't think that they are going to want that done.

Mr. Power. And also, you mentioned, Senator, the restaurant you are talking about has a labor cost of approximately 35 to 40 percent of the sales dollar taken in, and with tips, over half the money spent on the expense account goes directly in wages to the employee, where the other kind of restaurant that was substituted, like a McDonald or a Burger King, which I represent, and are members of our association, the labor cost is the first thing cut. It is down around 25 percent of the dollar spent in the fast food operation instead of 50 percent.

The Chairman. I think people ought to keep one more thing in mind. Most people are never going to be filthy rich, but they hope to accumulate enough to where they could have a nice retirement and be at least

affluent, be well to do in their community. If they get to that point, most folks don't want to have to leave home in order to lead a good life. Suppose, by dint of hard work, you are able to save something. By the time you retire, you at least like to have some place to go and spend some money, hope that somebody can show you a good time or wait on you and treat you nicely and show you some special attention. It is worth our while to keep a few places like that around.

It makes me think of that situation that happened in New York when I was at the Columbia Midshipman's school. They had this famous stripteaser, Margie Hart, performing on Broadway. It seems that Margie had a bunch of servicemen in the audience. She got a little bit overinspired and went a little too far, so she was picked up and brought down to the jailhouse. When she appeared before the magistrate, she was rather indignant that she had been arrested. The judge asked her what she had to say for herself. She said, well, your honor, that theater was filled with servicemen. He said, what's that got to do with it? She said, well, aren't those men fighting to protect America, fighting to save American womanhood? And he said well, I guess so. She said, well, what's wrong with showing them what they are fighting for? [General laughter.]

The CHAIRMAN. Now, we have something worth saving here in this great country of ours. We have some nice places where people can go out and have a nice meal and be well served and treated very nicely. Sure, it is nice to have the McDonald's to go to. It is also nice if you can afford it once in a while to sit down and have somebody show you some special attention and give you some special service, and if your people will work at it, we will preserve that. You can count on my vote. I'm going to vote to keep it for you.

Mr. JULIANO. Thank you very much.

The CHAIRMAN. Thank you very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL & RESTAURANT EMPLOYEES & BARTENDERS INTERNATIONAL UNION

Mr. Chairman and members of the Committee. I appreciate the opportunity you have given to me to appear in behalf of General President Hanley and all of the members of the Hotel and Restaurant Employees and Bartenders International Union to testify with respect to the Revenue Act of 1978 (H.R. 13511).

Those of us who represent workers have for some time been urging the enactment of appropriate tax reductions to stimulate employment. We have believed that this would, in some measure, protect against the continued erosion of jobs and, indeed, create new jobs which are sorely needed. To the extent that the tax program you are considering achieves that goal, we wholeheartedly support it. But this aspect of the legislation, which is vitally needed, had been totally overshadowed by the conscious, deliberate, and inexplicable injection into the debate of a political issue regarding what the President's men like to call the three martini lunch deduction. Indeed, their choice of such code words as the three martini lunch, or tax justice or tax equity is intended to shroud the real issue—JOBS.

Mr. Chairman, the House Ways and Means Committee deliberated this bill for many months. Although the issues impacting my members most severely had the highest media visibility, every amendment that was introduced in an attempt to limit deductions for legitimate business related entertainment expenses were categorically rejected by the Committee. It was our feeling that the Committee understood the true issue involved here, JOBS. If such amendment had passed, the impact on our International Union and the industry in general would be enormously negative and have a profound affect on employment and our overall

economy. In fact, we believe and hope that our testimony presented before your distinguished Committee will support contentions that those issues with the highest amount of media visibility in fact have the least amount of substance, and will be categorically rejected by your committee if the subject is even raised.

Just recently our union was privileged to testify before the Subcommittee on Taxation and Debt Management. We testified together with management in support of S. 1674, a bill which would repeal two IRS Revenue Rulings that would have an inequitable negative impact on gratuity employees. In 1976, your Committee wisely adopted a clarifying amendment which would have revoked Revenue Ruling 76-231. Since the ruling came after the House had reported out a tax bill, and therefore could not consider this issue, when the Senate and House conferees deliberated a moratorium was agreed upon nullifying the IRS ruling until January 1, 1979. Since a bill is now pending before your Committee which does the same thing you adopted two years ago, we would appreciate your considering this measure as part of your overall bill. The House has the exact same piece of legislation and intends to take it up in their Phase II tax hearings. We urge this committee to favorably consider S. 1674, which basically maintains the law that has been in existence since 1965, and presents a classic example where an agency of the Executive Branch of the Government has tried to circumvent the Legislative Branch by issuing administrative rulings intended to set aside legislation already in existence.

During the highly charged atmosphere of the political campaign for the Presidency in 1976, the President railed against the three martini lunch. Of course, at that time, he was simply a candidate for office with no responsibility. He and his staff, perhaps, could be excused for their lack of familiarity with the realities of the situation. However, after the election, the President and his men continued to propose, as part of a tax reduction measure, inclusion of a repeal of the business meal deduction. When my International Union learned of this, we decided to deal with the issue and the Administration directly. On June 10, 1977 we requested a meeting with the appropriate officials at the Treasury Department for purposes of conveying to them what we understood to be the facts of life for thousands upon thousands of members of my union and other workers in the food service and hospitality industry. At that time, we had not had the opportunity of completing or even undertaking any detailed analysis. But on the basis of our previous experience, we were able to make a conservative estimate, and so advise the Treasury Department, that a repeal of the business meal deduction would "cause the termination of 100,000 jobs, over 25,000 of which are now held by members of" the Hotel and Restaurant Employees and Bartenders Union.

We met with representatives of the Treasury Department on June 23, 1977. At that meeting they requested, quite properly, that we provide them with as much specific information as we could gather. We did so in a letter of August 11, 1977, and then followed up with more detailed information on September 9, 1977, letters which I request be included in the record. By this time we had undertaken extensive discussions with people in the industry and had begun an analysis of the available economic data, particularly from the Department of Commerce and the California Employment Development Department. On the basis of this data we were able to point out the potential enormity of the impact of a repeal of the business meal deduction. We have met with representatives of the Treasury Department and the White House several times simply in an effort to bring the facts of the potential unemployment to their attention. At no time, during any of those meetings, was any serious challenge made to the validity of our projections with respect to unemployment. Indeed, at no time was it suggested by anyone in the Administration that the Administration itself had conducted an employment impact analysis. And yet, for no other reason than undefined slogans such as tax equity and tax justice, the Administration is proposing a measure which will directly cause the permanent loss of thousands upon thousands of jobs of workers in the food service and related industries.

CONGRESSIONAL RESEARCH SERVICE ANALYSIS

In recognition of the fact that the proponents of repeal or modification of the business meal deduction had never bothered to undertake even the most rudimentary employment impact analysis the Congressional Research Service was commissioned to do a quick study.

Mr. Chairman, I am not an economist but certain things about that quick study illustrate how ludicrous its goals were. In the first place, the author of the study stated without equivocation that its purpose was to "examine what that impact will likely be and whether the magnitude will be relatively large or relatively small." If it were not for the potential devastating impact on those members of my union who would be affected by the Administration's proposal, I would be amused that even this Congressional Research Service expert didn't waste time trying to determine whether there would be no impact. She immediately started out with the assumption that there *would be* an impact on jobs.

Unfortunately, the CRS study was so speculative that I felt it imperative that it be analyzed professionally. We therefore commissioned a study by responsible economic consultants. They concluded, among other things, that:

"1. The Employment-Impact section of the CRS study is based on the most theoretical approach possible. It has little practical value because, for example, it omits many related influencing factors.

"2. The study admits to so many qualifications that one automatically questions the results.

"3. The study treats the restaurant industry (while neglecting the hotel industry) as a homogeneous unit. A serious analysis would reflect variations in types of establishments, e.g. between sit-down and fast food, and geographic concentrations, such as between urban and suburban areas.

"4. The shift in spending from one sector to another resulting from the proposed change is mentioned only briefly in the CRS study. However, the resulting alterations are very significant. Three that will cause the greatest disruptions are:

"(a) Existing jobs in sit-down restaurants will be abolished. That is, there will be a permanent loss of jobs, per se, in those establishments.

"(b) There will be a shift from permanent jobs to part-time jobs, which are less productive.

"(c) The individuals formerly occupying jobs in sit-down restaurants can anticipate extended periods of unemployment because of an inability to fill other jobs.

"5. The CRS study totally neglects related aspects of the impacted areas, especially on the labor force and the urban economies."

Mr. Chairman, I ask your consent that our Overview and Analysis of the CRS study be included in the record.

TREASURY DEPARTMENT ESTIMATES

Even the Treasury Department itself, has recognized the existence of a significant employment impact. In the detailed description and supporting analysis of the President's 1978 tax program, submitted to this Committee on January 30, 1978, the Treasury Department admitted as follows:

"It is estimated that the total employment reduction in the restaurant industry will be no more than 2%, at most, of all such jobs."

The food service industry is the second largest single source of employment for women generally in this country and for black women in particular. Therefore, it is reasonable to expect any disastrous impact to be felt by them in great measure.

Mr. Chairman, if only 2% of all jobs in the restaurant industry are lost as a result of this so-called tax justice proposal, as admitted by the Treasury Department, almost 80,000 people will be thrown out of work.

POLL RESULTS

I feel it is important, also, to deal with the misleading use made by the Treasury Department of a poll which I understand was taken by Congressman Fisher. According to Secretary Blumenthal, Congressman Fisher canvassed 22,000 of his constituents, asking them whether they would "favor or oppose elimination of business expense deductions for items such as lunches, club and other membership fees and the first class portion of air fares?" Mr. Blumenthal further reported that 72% said that they would favor elimination of the deduction. Putting aside, for the moment, the fact that the question lumped together a number of different kinds of deductions, what is most important is that the question was not framed in such a way as to put before the respondent the consequences of his answer. As Secretary of Labor Marshall has recently said about surveys: "If you

let me ask a question, I can get whatever answer I want to get. . . ." I feel confident that the response to Congressman Fisher's question would have been just the opposite if the question had been "Would you favor or oppose elimination of legitimate business meal deductions at the consequence of the loss of at least 80,000 jobs to workers in the food service industry?"

One prominent columnist when the issue was first raised, supported the Administration's proposal to repeal the business meal deduction.

But once he began to understand the job implications of such action, he became more reflective. As George Will said:

"It is politically difficult and morally questionable to 'reform' laws, rules, incentives and disincentives to which powerful interests and vulnerable lives have conformed, and on which they depend. A large state is rendered conservative in the sense that it must face that fact that society is not a Tinkertoy that can be tinkered with casually."

Society is not a Tinkertoy. And the lives of my members should not be played with for political motivation.

THE REAL ISSUE—JOBS

Every other proponent of the amendment to the business meal deduction that I have talked to has tried to ignore the real issue—JOBS.

Mr. Chairman, at a time when this nation is desperately trying to create jobs, when billions of dollars are being expended on the establishment of temporary public service jobs, it is unconscionable to be considering so-called tax reform measures which will have the effect of abolishing, permanently, thousands upon thousands of permanent job opportunities.

I also feel it is important to share with the Committee the benefits of my own experience in this industry. Although I am not an economist, I know the nature of the industry. The 2 percent job impact estimated by the Treasury Department will not be felt equally in the industry. Rather, it will fall most heavily on table top service establishments as opposed to the fast food chains. Specifically, it will fall most heavily on those establishments where my members work. Indeed in those establishments the impact is more likely to be as high as a 5-percent reduction in business.

And, in fact, if there is a 5-percent reduction in expenditures for meals in those restaurants, I am advised by our economists that the job loss in those establishments alone will amount to 135,000 people, many if not most of whom are my members.

My members are hard-working, tax paying people. They cannot pick up their stakes and move to another area or to another job so easily.

You know, Mr. Chairman, when I met with representatives of the President, they kept on talking to me about tax equity. I asked them why they weren't proposing a repeal of the deduction for the executive dining room, where my members don't find jobs, since they were proposing to reduce or repeal the deduction for business meals in restaurants where my members do find jobs. All they could say in response to this simple question of equity was that it was out of the question.

On behalf of all of the members of the Hotel and Restaurant Employees and Bartenders International Union, I implore this Committee to say that our President's proposal to reduce the deduction for legitimate business meals is out of the question and to reject this element of his tax proposals.

THE CRS PAPER—THE PROPOSED CURTAILMENT OF THE DEDUCTION FOR BUSINESS EXPENSES—GENERAL ISSUES AND THE EMPLOYMENT IMPACT IN THE RESTAURANT INDUSTRY

AN OVERVIEW AND ANALYSIS

(By Federated Consultants, Inc., Washington, D.C., March 1978)

On February 27, 1978 Senator Edward M. Kennedy (D-Mass.) released a study that had been prepared by the Congressional Research Service of the Library of Congress. It was titled, The Proposed Curtailment of the Deduction for Business Expenses: General Issues and the Employment Impact in the Restaurant In-

dustry. The paper is an analysis of proposed changes in the current tax treatment of deduction for certain business-related expenses.

One objective of the CRS study was a general examination of a wide range of items for which businesses can deduct all or a part of the expenses from their tax liabilities. The second was an analysis of the impact on employment in the restaurant industry resulting from the proposal to reduce the allowance for business meals to 50 percent from 100 percent.

The purpose of this paper is to explore the premise, analysis, and conclusions of the CRS study.

The remainder of this paper is divided into two major sections, in keeping with the construction of the CRS study. Part I reviews the first half of the CRS work, General Issues. Part II deals with the Employment Impact section of the CRS work.

I. REVIEW OF THE GENERAL ISSUES SECTION OF THE CRS PAPER

The General Issues section of the CRS paper is a cursory review of the broad issues contained in the tax proposals. Those proposals would alter the way in which many business-related entertainment expenses are deducted.

The General Issues section is divided into the following three parts:

"Present Treatment of Entertainment expenses;

"Problems with Current Treatment; and

"Previous Attempts to Deal with the Problem."

Each of these parts is treated individually below. We have provided an overview of its presentation, followed by a summary analysis of that treatment.

A. Present treatment of entertainment expenses

This part of the CRS paper outlines existing methods of taxation of business-related entertainment, including items such as yachts, club dues, theatre and sports tickets.

The proliferation of such expenditures is attributed a long-standing liberal allowance of deductions. The study explains that as being the result of subjective, rather than objective determination of whether the amounts are "ordinary and necessary" as required by the law, or are "lavish and extravagant" which are prohibited by the law.

Summary Analysis—

This section serves merely to present basic conditions under which certain business deductions are treated under current conditions. It is non-evaluative and does not attempt to reach any conclusion as to whether current allowances are economically costly.

B. Problems with current treatment

This part of the CRS study examines two actual or potential abuses of the current system. One deals with the benefits an individual can enjoy and the other cities a number of actual cases of abuse.

An individual employee, according to the study, personally enjoys the benefits of entertaining a client while accruing no tax liability. For example, an employee of an organization entertains a client at dinner and a play, and simultaneously derives personal benefits from those activities. This is considered, by the author, as a form of compensation on which the employee pays no tax.

The CRS study then portrays a number of specific historic instances of proven abuse of the system. These are examples of individuals who have used entertainment-related expense accounts for solely personal purposes over extended periods of time.

Summary analysis

There appears to be little practical value to this part of the paper. To say that employees pay no tax on the value they accrue from entertaining clients provides the obverse example of those employees who find such entertaining a negative aspect of their jobs.

Then, to cite examples of abuses is analogous to providing examples of welfare abuses as symptomatic of the failure of the entire system. There is no reason to imply that the system should be changed to correct abuse.

C. Previous attempts to deal with the problem

The legislative history of earlier attempts to change the tax system is explained in this part of the CRS paper. The last significant effort occured in 1961 and failed.

Summary analysis

A review of the legislative history from 1961 to the present would have been more useful if the causes for failure were provided. It would have added some value to an otherwise meaningless section.

Major Conclusions

Two basic conclusions can be drawn regarding the first part of the CRS study. One is that it establishes very little that is relevant or of value to the present debate. It dwells on the petty and meaningless. It arrives at no conclusions and provides nothing of the past that will assist in the present.

The second, and most important, conclusion is vewing the first part in perspective; it is not relevant to the second, or succeeding section. The following characteristics indicate the differences:

1. The subject matter of the two parts is totally disparate.
2. There is no apparent or subtle connection between part 1 and part 2 of that paper.

There are, in effect, two CRS papers.

II. REVIEW OF THE EMPLOYMENT IMPACT SECTION OF THE CRS PAPER

The Employment Impact section of the CRS paper is the most relevant to the present situation because of its special focus on an issue of importance.

This part of the paper employs a highly theoretical supply-demand model. It assumes that changes in demand for labor are predictable from changes in the demand for restaurant meals as they are affected by alterations in the tax law, absent any other influencing factors.

This part of the CRS study is divided into four separate sections, according to subject matter. Parts one and two, because of their nature, are more closely connected, as are parts three and four. The first two parts are designed to analyze the impact on prices and income resulting from the changes in the tax law. The last two parts are designed to anticipate the impact of those changes on the restaurant industry and its work force.

A. Measurement of the relative price effect

This section of the CRS paper attempts to quantify the potential impact of tax law changes. First it assumes that a lower deduction for business-related meals will raise the price of those meals. In 1976 just over $55.2 billion was spent for meals consumed on the premise and that 5.8% of that total was expended for business-related purposes.

It is possible, according to the CRS, to predict the level of change in that amount by one of two different processes, as follows:

Price Elasticity, or

Postaulation of a Curved Demand Function.

The price elasticity model in the CRS paper results in a decline of 28% in demand for entertainment, or a 1.6% decline in total quantity demanded.

Since that amount might be excessive, the study proceeds to the Curved Demand Function. That model produces a reduction of 1.3% in total quantity demanded.

Finally, in apparent frustration, the paper concludes that a 1% change might be the most suitable answer.

B. Aggregate income effect

This part of the CRS paper is designed to reflect changes in aggregate income produced by the total tax package, including that which will reduce personal taxes.

In citing an earlier study the conclusion is reached that aggregate income will rise, generating in turn an increase in personal consumption expenditures of 1 percent.

The CRS paper draws one conclusion from the two analyses: that is, if demand declines by 1 percent because of rising restaurant prices, and an increase in ability to purchase restaurant meals rises by 1 percent, the effect will be a "wash-out."

C. Normal growth rate in the restaurant industry

In recent years employment in the food sector of the economy has been rising more rapidly than that of total employment.

That growth rate, the study states, reflects "in part increasing tastes for dining out."

D. Combined effects on employment

The final section of the CRS paper is an attempt to reconcile earlier projects and the impact on the total labor force of the foodservice industry.

It concludes, because of the wash effect noted above, that total restaurant industry employment, will continue rising, although perhaps at a less rapid rate than anticipated.

Major conclusions

1. The Employment-Impact section of the CRS study is based on the most theoretical approach possible. It has little practical value because, for example, it omits many related influencing factors.

2. The study admits to so many qualifications that one automatically questions the results.

3. The study treats the restaurant industry (while neglecting the hotel industry) as a homogenous unit. A serious analysis would reflect variations in types of establishments, e.g. between sit-down and fast food, and geographic concentrations, such as between urban and suburban areas.

4. The shift in spending from one sector to another resulting from the proposed change is mentioned only briefly in the CRS study. However, the resulting alterations are very significant. Three that will cause the greatest disruptions are:

(a) Existing jobs in sit-down restaurants will be abolished. That is, there will be a permanent loss of jobs, per se, in those establishments.

(b) There will be a shift from permanent jobs to part-time jobs, which are less productive.

(c) The individuals formerly occupying jobs in sit-down restaurants can anticipate extended periods of unemployment because of an inability to fill other jobs.

5. The CRS study totally neglects related aspects of impacted areas, especially on the labor force and the urban economies.

HOTEL AND RESTAURANT EMPLOYEES AND BARTENDERS INTERNATIONAL UNION,
Cincinnati, Ohio, September 9, 1977.

Mr. DONALD C. LUBICK,
Deputy Assistant Secretary, U.S. Department of Treasury, Washington, D.C.

DEAR MR. LUBICK: This is in response to your request for a description of the situations which would be impacted by proposals for tax reform which we understand to be pending in your Department, as well as some additional data with respect to the potential impact of tax reform legislation on employment in the hospitality industry. Our comments deal with two proposals, both of which have been made by Senator Kennedy and which are reportedly being actively considered by the Administration.

As we understand them, the first such proposal would limit deductions for attending conventions to necessary travel (presumably tourist class), the government per diem rate for the area in question, and registration costs (excluding costs attributable to food and entertainment). Also, deductions for out-of-town food, lodging and business entertainment would be limited to the government per diem allowance for the area. And, secondly, no deductions would be permitted for business meals.

The first of these proposals, of course, aimed at expenses which are estimated to account for at least 54.3 percent of the annual revenue of the lodging industry.[1] The impact of these proposals can best be described by the following two examples:

Example A: A hotel in a major Eastern business city whose income is derived primarily from business and convention trade. It employs approximately 800 full-time employees and has a food and beverage volume of approximately $10,000,000. Management of the hotel estimates that a typical patron spends spends $30 per day for food and beverages, and that this constitutes 50 percent of the hotel bill. Because of the proximity of "counter top service" facilities and fast food establishments, the comptroller of the hotel conservatively estimates the loss of 40 percent of the hotel's $10,000,000 food and beverage volume. Such

[1] Based on estimates of the United States Department of Commerce. U.S. Travel Data Center. According to these data, in the business downturn year of 1975, 54.3 percent of the lodging industry's annual revenue was derived from business and convention trade, as opposed to pleasure and other sources of income.

a reduction in volume would result in a loss of between 300 to 350 jobs of restaurant employees, kitchen staff, cleaning staff, set-up staff housemen, maids and maintenance personnel. In this instance 70 percent of these employees are minorities.

Example B: Officials of a major New York hotel estimate that if the tax proposals curbing such expense account and other expenses were enacted into law, between 10 and 20 percent of its gross annual rooms revenue, between 20 and 40 percent of its general food and beverage sales, and between 40 and 75 percent of its annual banquet revenues would be affected. Such a loss in their hotel would result in a layoff of 160 to 350 full-time employees, or between 10.7 percent and 23.3 percent of their total staff.[2]

We have, by way of example, applied these projections to employment in the lodging industry in the State of California. That industry, in 1976, employed 93,500 people.[3] If the most conservative of the three estimates were applied, it would lead to a reduction in employment of 10,000 jobs in that state alone, reducing the level of employment to its pre-1973 level. However, this level of new unemployment could increase to 21,785 persons, in that one state alone, in this one industry alone, if the higher projection were realized.

10 percent—15 percent—20 percent........................... in rooms sales.
20 percent—30 percent—40 percent........................... in general food and beverage sales.
40 percent—60 percent—75 percent........................... in banquets.
equals
160—225—350... Employees laid off.
or
10.7 percent—15 percent—23.3 percent of total staff.

The magnitude of these examples can more dramatically be seen by the simple application of the data to the industry as a whole.[4]

The lodging industry, in 1975, employed approximately 980,000 people.[5] If the worst fears of the projections in Example B are realized, the potential for layoff exceeds 228,000 employees in the lodging industry alone. Even if the lowest or most conservative projection were used, a layoff of nearly 105,400 employees can be anticipated in the lodging industry alone.

Unfortunately, our estimates of the impact on employment in restaurants are based exclusively on projections made with respect to food and beverage sales in hotel and motel restaurants. Therefore, further refinement of the data may become necessary. However, we believe that despite these limitations, the data accurately reflect the order of magnitude of the impact of the "tax reform" proposals.

As can be seen by our above described examples, reputable sources in the industry anticipate between a 20 to 40 percent reduction of general food and beverage sales. Since these figures are projections made by hotels oriented toward business and convention trade, we will use the most conservative 20 percent estimate and then halve that figure to err, if at all, on the side of conservatism.

In 1975, the State of California reported that its 26,030 reporting eating and drinking places, employed 391,285 employees at a total annual wage of $1,727,-009,663.[6] If the tax proposals have only a 10 percent impact on this industry, it will lead to a loss of almost 40,000 jobs and $172,000,000 in wage earnings in one state alone. Applying the 10 percent factor to employment in the industry nationwide will yield a job loss of 329,000 jobs.[7]

In summary, therefore, it can readily be seen that by most conservative projections, the tax reform proposaals may throw 434,000 hospitality industry em-

[2] Let me also bring to your attention the experience of just one hotel in Montreal after the United States imposed a $46 per diem allowance on American business executives traveling in Canada. I am reliably advised that the lost convention business to this one hotel amounted to $1.5 million per annum, or 10–12 percent of its total convention business. More specifically, we understand from submissions made to the Minister of Finance in Ottawa, Ontario between 40 and 50 U.S. conventions which would have generated income of $20 million over the next six years were cancelled.

[3] California Employment Development Department, Wage and Salary Employment, By Industry 1972–1976.

[4] The validity of applying this data to the industry as a whole is based on the fact that the major hotel and motel chains now account for over 40 percent of all U.S. hotel/motel rooms.

[5] U.S. Department of Commerce, Statistical Abstract of the United States, 1976.

[6] California Employment Development Department, California Employment and Payrolls, October-December 1975.

[7] According to the Statistical Abstract of the United States, 1976, there were 3,298,000 jobs in eating and drinking places in the United States in 1975.

ployees out of work, a figure substantially greater than even our worst fears, just a few months ago.

There is an extended impact to these projections, which lies in the lost wage earning capacity and, in turn, the lost tax revenue from these newly unemployed persons. Although the Treasury Department is in a much better position to make projections in this area, we would suggest that the magnitude of this impact can be judged by the simple use of basic wage data. So, for example, in the State of California in 1975, the payroll for the 90,000 employees in the lodging industry was approximately $465,000,000. If between 10,000 and 21,785 of these persons become unemployed, their share of the payroll (between $50,-000,000 and $110,000,000) would be lost.

If the ten percent loss factor we have previously utilized with respect to the restaurant industry were applied to wage earning capacity in California, it would result in a loss of $172,000,000.

These figures, of course, must be multiplied by a factor of 10 to derive the lost wage earning capacity nationwide, occasioned by the impact of these tax proposals on the hospitality industry.[8]

Such losses, totalling between 2 billion and 3 billion dollars in wage earning capacity, nationwide, impact significantly on the Treasury because of lost tax revenue and increased costs of social services, such as unemployment insurance, welfare, etc.

In short, even if these most conservative estimates are reduced further, we are faced with potential economic catastrophe for tens of thousands of this union's members and hundreds of thousands of employees in the industry as a whole.

It is with great urgency and the deepest of fears that we express our concerns about these ill-conceived though cosmetically appealing tax proposals.

Sincerely,

EDWARD T. HANLEY,
General President.

HOTEL AND RESTAURANT EMPLOYEES AND
BARTENDERS INTERNATIONAL UNION,
Cincinnati, Ohio, August 11, 1977.

MR. DONALD C. LUBRICK,
Deputy Assistant Secretary, U.S. Department of Treasury,
Washington, D.C.

DEAR MR. LUBICK: At the outset let me express my appreciation to you for the courtesies you extended to Robert Juliano, Legislative Representative of the Hotel and Restaurant Employees and Bartenders International Union, and to Gerald M. Feder, our counsel, when you and other representatives of the Treasury Department met with them on June 23, 1977. It was of the most utmost importance to our members to be able to share with you our concerns over the direct impact on employment in the food service and lodging industries of a limitation or repeal of the provisions permitting tax deductions for business meals.

As a matter of deeply held principle, our union opposes tax abuses and tax loopholes which are available only to few persons of privileged class to use for tax avoidance. However, the legitimate use of a business meal deduction does not fall within that category. Admittedly, the business meal deduction has high visibility. But, the restoration of faith in the equity and justice of the tax system does not require the artificial sacrifice of a tax provision which is job producing and responsible for generating significant economic activity in our society.

As we have already indicated to you, if proposals to eliminate the tax deduction for business lunches and business dinners were to be enacted into law, over 25,000 members of our union would lose their jobs. In addition, if any legislative proposals are enacted which would unfairly restrict not only spending for business lunches and dinners, but also the amount of money a person attending a legitimate convention or trade show can deduct, the devastating result would probably mean a loss of jobs for an additional 50,000 to 100,000 of our members.

Since our union represents approximately one-fourth of the workers in the hospitality and food service industries, we can assume that such tax proposals could result in the loss of almost one-half million jobs for gainfully employed, productive workers.

[8] California accounts for slightly over 10 percent of the Nation's employees in eating and drinking places and slightly under 10 percent of its lodging industry employees.

At your meeting with Mr. Juliano, you asked if we could provide some hard data with respect to these problems. Specifically, you asked if we could describe the situations which would be impacted by the pending proposals and the basis of our estimates. Also, you inquired as to the average cost of meals. Finally, you solicited alternatives which would limit or inhibit possible abuses without a detrimental impact on employment in the industry.

We have already discussed this matter extensively with elements in management with whom we have collective bargaining relationships. From them we have obtained the following examples:

Example A. A hotel in a major Eastern business city whsoe income is derived primarily from business and convention trade. It employs approximately 800 full-time employees and has a food and beverage volume of approximately $10,000,000. Management of the hotel estimates that a typical patron spends $30 per day for food and beverages, and that this constitutes 50% of the hotel bill. Because of the proximity of counter "tap service" facilities and fast food establishments, the comptroller of the hotel conservatively estimates the loss of 40 percent of the hotel's $10,000,000 food and beverage volume. Such a reduction in volume would result in a loss of between 300 to 350 jobs of restaurant employees, kitchen staff, cleaning staff, set-up staff, housemen, maids and maintenance personnel. In this instance 70 percent of these employees are minorities. If the tax proposals also impact on deductions for convention expenses, the estimates become meaningless because the hotel will have to completely change the nature of its business just in order to survive, if indeed, it can survive.

Example B: A major New York hotel estimates that if the tax proposals curbing expense account and other expenses were enacted into law, 20 percent of its gross annual rooms revenue, 40 percent of general food and beverage sales, and over 75 percent of its annual banquet revenues would be affected. Such a loss in this hotel would result in a loss of 350 full-time employees, or 23.3% of their total staff. All of these employees would be members of our union.

Since these two hotel properties are representative of their corporation, we stand to lose between 6,000 to 7,500 members with just this one hotel corporation. Unfortunately, our initial estimates of total loss of employment may be on the conservative side.

We are in the process of securing as much data for your use as possible, both from the hotel industry and from the restaurant industry. But, in the meantime, I want you to know that this is a matter of absolute priority for our union. Because of the labor intensiveness of our industry, such tax proposals would have a devastating impact on our members and other employees in the tourism industry.

I anticipate that we will be prepared to provide you with further facts in this matter during the last week in August, and would greatly appreciate it if you would be able to meet with my representatives, again, at that time.

Sincerely,

EDWARD T. HANLEY.

STATEMENT OF THE NATIONAL RESTAURANT ASSOCIATION

The National Restaurant Association supports the reductions of individual and corporate tax rates as contained in H.R. 13511.

We strongly support the restructuring of the corporate income tax schedule by graduating the rates through two new tax brackets and reducing present law marginal rates.

We support the House decision to make permanent the 10 percent investment tax credit and to extend its use to 90 percent of tax liabilities. We strongly support the decision to extend the credit to rehabilitation of commercial and industrial structures but urge that it also apply to the construction of new commercial and industrial structures.

We support the changes made respecting the taxation of capital gains and urge approval by the Senate.

We are deeply concerned with the proposal earlier this year to limit the deductibility of business promotion meals. It is an "ordinary and necessary" cost of doing business just as other promotional business activities are. Small businesses would be adversely affected relative to larger established companies as it is often the only practical, affordable form of promotion. Sales and economic health of some 260,000 restaurants employing 3 million people would be harshly affected.

according to the Treasury, by a sales decline of $1 billion and a job loss of 50,000 to 70,000. Our estimates are slightly higher. Most vulnerable to this job loss are women, teenagers, blacks and other minorities. There would be a loss of Federal and state tax revenues of $144 million and increased unemployment compensation costs amounting to $70 million or more.

STATEMENT

Mr. Chairman and members of the committee: I am Robert Neville, Washington Counsel for the National Restaurant Association. I am accompanied by Douglas Bennett, our tax counsel.

We appreciate the opportunity to present the views of our association whose members, ranging from thousands of individual entrepeneurs to the major corporations in the hospitality industry, are engaged in all types of foodservice in every State of the Union.

With on exception, we have confined our testimony to those provisions of Revenue Bill of 1978 (H.R. 13511) which we believe will have the most direct effect upon the economic health and continued solid growth of the foodservice industry. A proposal made earlier this year by the Administration to place extensive limitations on the deductibility of business promotion meals was considered and overwhelmingly rejected by the House Ways and Means Committee and is not mentioned in H.R. 13511. If enacted, this proposal would have such adverse effects on employment, revenues, and the economic viability of a major segment of our industry that we believe your Committee should be aware of those effects. So, we have included a discussion of that proposal.

I would also like to mention that earlier this month we testified before Senator Byrd's Subcommittee on Taxation and Debt Management in support of S. 1674 co-sponsored by Senators Laxalt, Cannon, Curtis and Dole relating to recordkeeping and reporting of charged tips. We trust that the Finance Committee will again, as it did in 1976, favorably report this measure as part of the tax bill presently before you.

Restructuring of corporate income tax

We applaud and strongly support the restructuring of the corporate income tax schedule by graduating the rates through two new tax brackets and reducing the marginal rates of the present law.

We believe this change will be particularly helpful in establishing and maintaining the economic health of small businesses in our industry. The much less precipitious rise in the tax rate will encourage the kind of risk taking that is essential to economic development and the creation of jobs.

We feel also that the graduated rates will provide much more flexibility to small business owners in deciding the form of business organization most suitable to their enterprise.

Investment tax credit

We support the House decision to make permanent the 10 percent investment tax credit and to extend its use to 90 percent of the tax liability. Extension of the credit to rehabilitation of commercial and industrial strucures is a step in the right direction which we heartily support. We have supported and continue to urge that it also apply to the construction of *new* commercial and industrial structures. Our industry, composed primarily of small businessmen, competes at a comparative disadvantage for capital, most of which is designated for construction purposes. Retail establishments in our industry create more jobs per dollar invested than most industrial enterprises.

Capital gains

We view the changes made in the taxation of capital gains by H.R. 13511 as particularly beneficial to persons owning small business enterprises and as a necessary step in encouraging the creation of the capital essential for economic growth. In our view the present law does not encourage the acceptance of risk essential to capital formation.

Proposals to Limit Deductibility of Business Meals

The business promotion meal is a legitimate cost of doing business. Proposals to limit its deductibility rest on arbitrary judgments unrelated to the general principles which govern our tax policy.

Tax Policy Considerations

The historical development of the deductibility of travel and entertainment expenses begins in 1914 when the Internal Revenue Code was adopted and certain deductions were allowed. Among these were expenses which related to the furtherance of business activities. After all, if business prosperity increased tax receipts, then it was only fair to allow deductions for those costs which were the catalysts for that financial success.

Almost 40 years ago, in 1939, a broader, more complex taxation system was adopted which included a simple provision now identified in our tax laws as Section 162 relating to trade or business expenses. Generally stated, it prescribed "as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .".

In 1962, Congress enacted a new travel and entertainment provision—Code Section 274. Without going into the details of the regulations issued pursuant to Section 274, it is clear that the fundamental policy decision made by the Congress was that business entertainment expenses are legitimate "ordinary and necessary" costs of doing business.

The law today continues in this form and perhaps is best described in a simple statement made in 1963 by Commissioner of Internal Revenue Mortimer Caplin when he stated that ". . . only one question needs to be answered affirmatively: 'Was your primary purpose to further your trade or business?' or, putting it another way, 'Can you reasonably expect a business benefit from your relationship with this guest?' " We think this is still a reasonable standard.

All other forms of promotion and advertising are fully deductible, because they promote legitimate business interests and are productive in increasing business revenues. The business meal serves the same purposes, with the added benefit of increasing the time available for productive work. For many businesses other forms of promotion and advertising are not cost effective to reach a limited market, or are too expensive for small businesses and businesses serving restricted markets.

If the business meal were not productive, it would not be the means of choice, for clearly businesses would not use it solely to gain the limited benefit provided by a tax deduction.

The argument that the deduction for a business meal is inequitable because not all taxpayers can claim it is fatuous. The tax code contains many deductions or exemptions available only to certain classes and groups of taxpayers. The deduction for interest on home mortgages and child care deductions are but two that come readily to mind. There are many more, all adopted for sound economic or social reasons. Benefits to employees, for example, vary widely depending upon the industry in which they are employed and the business success of the employer. Many of these benefits are clearly designed to provide entertainment, enjoyment, or monetary advantages to the employees for whom they are provided.

Other clearly deductible business expenses for furniture, equipment, decor, and business location result from business decisions to promote the comfort—and even enjoyment—of employees and potential customers.

To insure absolute equality in these matters would inject the government into business management decisions and give it a control over business operations on a scale completely foreign to our society and form of government.

We do not defend any abuses that may occur, nor can we accept evidence of occasional abuses as valid argument for abandoning demonstrably sound economic or social programs. If the existence of occasional abuses were to invalidate otherwise sound policy, there would be few social or economic government programs that could survive.

The business meal is an effective tool for increasing business productivity. In many businesses, especially small businesses, it is the most effective and economical vehicle for promotion. To contend that its cost is not a legitimate business expense and then to tax the gains it produces is an absurd inequity and a travesty of sound tax policy.

The government itself has long accepted the validity of the business meal as a sound investment in promoting the business of government. All major departments of the government seek and acquire representation funds for precisely this purpose—and these funds are not simply a deduction against tax obligations. They are paid one hundred percent from tax revenues.

Profile of the industry

A profile of the foodservice industry is an essential foundation for any analysis of the economic and social effects of proposals to limit the deductibility of business promotion meals.

Our studies estimate the total revenues of the industry in 1977 at 85.9 billion dollars. It is an industry of over 500,000 establishments employing over 5 million people in jobs directly concerned with food preparation and service. This figure does not include the headquarter's staffs of the corporations in the industry.

About 5.5 percent of all employed persons work in jobs directly concerned with the preparation and service of food. After government and medical and other health services, the foodservice industry is the country's leading employer.

The composition of the workforce in the industry is strongly oriented toward those segments of our society which are the most vulnerable to unemployment. The industry is labor intensive and is unique in the market it offers for unskilled, entry level employment. In weighing the economic and social effects of proposals that even proponents admit will reduce employment in the industry, it is important to note that 68.5 percent or 2.8 million of the industry's employees are women, while only 7.6 percent of all employed persons are women; 31.3 percent or 1.3 million of the industry's employees are teenagers as compared with only 17 percent of all employed persons; and 13.8 percent or 565,000 are black or other minorities, but these represent only 6 percent of all employed persons.

Since it deals in the preparation and sale of perishable products to individuals and groups on a personal service basis, the industry is labor intensive, but its demands for capital are equally intensive. For example, in 1976 table service restaurants required an investment per seat of $2,236, where the building and land is owned, and an investment of $1,535 per seat, where the building is leased.

Profit margins for table service restaurants average 5.4 percent. According to IRS data for eating and drinking place companies of all types, the profit margin is about 5 percent.

Productivity measured by volume of sales per employee is markedly lower in the foodservice industry than in any other retail industry and the average annual rate of gain in productivity is only 1 percent from 1958 to 1976 as compared with an average annual growth of 2.8 percent in private industry as a whole.

We estimate that foodservice sales will increase by 9.7 percent in 1978 to $93.7 billion but, as we discuss below, this encouraging gain will not hold at this level for that segment of the industry that would be affected by this proposal.

Cost of doing business, including payroll, utilities, and occupancy costs, varies widely between regions of the country, and, of course, between city centers, neighborhood, and suburban restaurants. For example, in the latest survey (1972), the difference in the cost of doing business per seat in table service ranged as much as 56 percent between regions. This did not include food costs, which also vary widely between the various regions.

To illustrate the wide regional disparity in meal costs as a result of these regional variations in the cost of doing business, a survey of selling costs conducted in 1978 shows a range of medium lunch costs from $3.30 in Cincinnati to $7.45 in New York, for a lunch of comparable components.

Segment of foodservice industry affected

With these facts as a foundation, we can concentrate on the segment of the industry most affected by any proposal to limit the deductibility of business meals.

It is our understanding that proposals to limit the deductibility of business meals apply only to those meals involving entertainment of another person or persons. It has not been proposed to limit the deductibility of meals consumed by persons in a business travel status.

Assuming that legislation will reflect this concept, the effects on industry revenues, employment, and taxes would be major. For example, with industry revenues in 1977 at over $85 billion, revenues in that portion of the industry where entertainment is likely to occur were $52.2 billion and any limitation on the deductibility of business meals would affect some 260,000 establishments. We have excluded from these calculations the revenues from fast food limited menu establishments and from foodservice operations in institutions such as schools, colleges, hospitals, etc.

Revenue effects

As we have mentioned, the revenues in that portion of the industry where entertainment is likely to occur amounted to $52.2 billion last year. The number of employees directly concerned with the preparation and service of food in this segment of the industry is about 270,000. The estimated federal income taxes generated by those employees is $3.047 billion and the estimated federal income taxes from business producing $52.2 billion in food and beverage sales is $900 million. The state sales tax receipts generated from these sales totals about $2.198 billion. In sum, we are speaking of $6 billion in tax revenues generated by that segment of the industry affected by this proposal. Of course, state and local income taxes would increase the tax revenue total even further, as would the taxes generated from businesses and employees in allied industries.

The Treasury Department's most recent estimate of the revenues produced by entertainment food and beverage sales is $3.777 billion. Treasury estimates the after-tax cost to business for this expenditure at $2.115 billion and assumes that, if the deductibility of business meals were limited, business would still hold its cost for entertainment meals to the same after-tax dollar amount. We do not agree that business will continue to budget for promotion meals at the same after-tax cost level, however, we have adopted its assumption and methodology for illustration and comparison. Even the Treasury acknowledges that this drop in business entertainment meals will amount to about $1 billion. This will reduce business entertainment meal expenditures to $2.712 billion, a decline of 28 percent.

A study recently conducted under National Restaurant Association auspices concludes that business meal expenditures are somewhat higher than Treasury estimates. Our study places these expenditures at $4.5 billion as opposed to Treasury's estimate of $3.777 billion. If we use Treasury's method of calculating the net effect of the proposed limitation on deductibility against our estimate of $4.5 billion spent for business meals, we would place the after-tax cost to business at $2.520 billion. If we then follow Treasury's assumption that business would continue to spend the same amount for business meals, sales of such meals would decline by about $1.2 billion.

Since we estimate an increase in sales by this segment of the industry to $56.7 billion in 1978 over $52.2 billion in 1977, if $1.2 billion in sales is lost, sales for 1978 would advance to $55.5 billion, an increase of only 6.3 percent. Both USDA and the National Restaurant Association forecast menu price increases of 7 percent in 1978. Thus, the result would be an actual decline in total real sales in this segment of the industry.

As we have noted, net profits before taxes in this segment of the industry are approximately 5 percent of sales. Sales of $52.5 billion in 1977 thus would produce a net profit of about $2.61 billion. In 1978, projected sales of $56.7 billion would produce a net profit of $2.835 billion. However, Treasury's projected drop of $1 billion in sales would account for nearly 40 percent of the industry's profit and, even if the industry were able to hold profits at 5 percent of sales, $60 million in profits would be lost.

Employment effects

The Treasury Department estimates a reduction in employment in the industry of 52,500 under its projection of a $1 billion reduction in sales of business entertainment meals. This represents 1.8 percent of the 3 million employees in the segment of the industry where entertainment is likely to occur. A loss of 52,500 jobs represents more than 50 percent of the expected gain in employment of 100,000 from 1977 to 1978 in this segment of the industry.

If we use Treasury's method of calculating employment loss and the estimated sales loss of $4.7 billion found in our recent survey, the loss of jobs will total 63,000. This job loss could be substantially higher, depending upon the reaction of the business customer to any limitation on deductibility and on the continued economic viability of the affected restaurants.

Reduction in taxes paid

Estimated individual income taxes generated from employees in that segment of the industry where entertainment is likely to occur is $3 billion. A $1.2 billion drop in sales as predicted by the Treasury would result in a $94 million decline in individual and business Federal income taxes. State sales tax revenues would likewise decline about $50 million.

Total tax loss in both federal income and state sales taxes would be about $144 million. However, with the unemployment predicted, even by the Treasury, it is reasonable to expect increased government expenditures in the form of unemployment compensation. We estimate these costs would rise by $70 million or more.

Against these predictable economic, social, and tax losses, Treasury foresees a revenue gain from the limitation on deductibility of business meals of only $680 million.

Treasury shrugs off the predictable job losses on the theory that growth of the industry will produce jobs for all those displaced. But this ignores the reality that these employees are in a segment of the industry where their training and experience is highly specialized and not readily adaptable to other segments of the industry or to other industries. A significant element in the human equation here is that this group of unemployed will have a large percentage of persons in minority groups and persons lacking training and education in any other field of work.

Adverse effects on expansion of the industry

The full economic and social effects of the proposal cannot be measured solely by its impact on employment, revenues, and reduction in tax receipts at the federal, state, and local levels. The predictable effect on expansion in the industry apparently has received no consideration by its advocates.

In an effort to determine overall effects on a variety of foodservice and hotel operations, the National Restaurant Association commissioned detailed case studies of the effects of the Administration's proposal on twelve different operations located in different parts of the country. These case studies produced revealing information on the effects on employment, revenues, and on future growth.

The restaurant and hotel industries are considered relatively high-risk investments by the financial community, with only a modest rate of return (5 percent is average) to compensate for the risk. All twelve firms have stated that any plans for future growth would be placed "on hold" while the disposition of this proposal is made and its long-term effects are assessed should it be passed.

Some of the effects on restaurants in these case studies are particularly revealing and serve to bring home the wide range of effects of the Administration's proposal, even if it produced only a modest decline in business.

For example, a Louisiana restaurant whose annual sales approach $3 million, enjoys a 4.4 percent profit. A ten percent decline in business would produce an 18 percent decline in profits; a reduction of 13 jobs from the present 142 employees; a reduction in spending on the local economy of $233,400; and a loss of $51,000 in tax revenues.

An Oregon restaurant, with modest prices, but extensive expense account business, has annual sales of $1.2 million and generates after tax profits of about 1.8 percent. It finds that just a 10 percent decline in sales would reduce profits by 93 percent. This 10 percent in sales would force a reduction from 143 to 134 employees; a decline in local spending by the restaurant of $89,635; and a 13.6 percent reduction in taxes totaling $22,752.

A regional restaurant chain illustrates the effects on a relatively small multiunit company. The company owns eight restaurants with combined annual sales of about $8.5 million, which generate a profit of just over 3 percent for their owners. If business declines just 10 percent, profits would fall about 22 percent: employment would be reduced from 1,054 to 1,008 employees; spending on local economies would be reduced by $689,000; and tax payments would be reduced by $142,000.

Comparable results occurred in the case studies for every restaurant and hotel studied. In every case, a modest decline in sales has a disproportionate effect on profits. This fact illustrates a point that must not be lost in assessing the effects of proposals to limit the deductibility of business meals: A great portion of the cost of doing business consists of expenses that go on on matter what happens to sales volume. Interest expenses, lease payments, repairs and maintenance, utility costs, insurance, licenses and permits do not fluctuate with sales. Even the cost of food and beverages which varies directly with sales, cannot be cut as a percentage of sales without affecting quality. Accordingly, cost reductions must be sought elsewhere and, unfortunately, payroll is the one area which must be reduced when business declines.

The case studies graphically illustrate the often disproportionate ripple effects which even a modest decline in sales can have in the restaurant industry on employment, purchases in the local economy, taxes paid, and on plans for future development which creates jobs.

Business Reaction to a Limitation on Deductibility of Business Meals

As we have noted, the Treasury Department assumes that spending on the business meal would continue at the same dollar amount, if the proposed limitation on deductibility were adopted. We cannot agree with Treasury's assumption, even though the results it would produce clearly support our view that the proposal is not sound tax policy.

The business meal is a tool to enhance the productivity of a business. It is promotional in nature and, in some cases, accomplishes the same ends as advertising. For some small businesses selling products or services of a personal nature, or to a limited and well defined market, it is the most effective promotional vehicle available. For larger firms, the business meal must compete with other fully tax deductible promotional means. It is contrary to human experience to assume that the increase in cost brought about by the proposed limitation will not strongly affect business judgment in determining how resources for promotion will be spent. As compared to other promotional activities, this proposal will place the business meal at an obviously serious competitive disadvantage. We believe the Treasury's assumption that the same amount of money will be spent for fewer meals is born of a desire to lessen the adverse economic effects which they acknowledge will occur. It is logical to expect that this competitive disadvantage will produce a major shift by business to other methods of promotion which are entirely deductible.

Proponents of limiting its deductibility contend that the business meal is paid for by the taxpayer. Under this peculiar reasoning, everything a business spends to conduct its business is paid for by the taxpayer. Wages and salaries, raw materials, office equipment and furniture are all business expense deductions and, in this warped reasoning, can be said to be paid for by the taxpayer. If it can be said that all business and personal revenues belong to the government, then it can be said that any deductions for the cost of doing business are paid for by the taxpayer. We do not understand this proposition to be a tenet of our nation's social and economic philosophy.

Summary

The business meal is an ordinary and necessary business expense. It enhances productivity in a cost effective manner or it would not be used. The predictable economic and social effects in the loss of jobs, reduced business expansion, and the losses in federal, state, and local taxes demonstrate that this is a bad idea born of a false perception of the nature of the business meal and its function in the conduct of business.

Statement of the American Hotel and Motel Association

The American Hotel and Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands having a membership of approximately 7,000 hotels and motels representing about 925,425 rooms. The total of employees directly employed in our industry is approximately 860,000. The industry has an annual payroll and related expenses of $5.7 billion, of which $1.8 billion is related to food and beverage revenue.

The proposal to curtail tax deductions for business expenses goes right to the heart of our business. AH&MA commissioned a study conducted by two respected national accounting firms, Laventhol & Horwath and Harris, Kerr, Forster & Company. The study showed the following:

I Accounting Firm Study

It is estimated that approximately 860,000 people were employed in the lodging industry in 1977 on either a full or a part-time basis. It is worthwhile to note that the lodging industry is a large employer of unskilled labor (who are also traditionally the largest group on the unemployment roles) as shown by the following labor mix.

	Percent
Professional workers	2.4
Managers, officials and proprietors	15.2
Salesworkers	.8
Clerical workers	16.9
Craft and kindred workers	2.9
Operatives and kindred workers	2.8
Service workers	59.1
Non-farm workers	.9
Total	100.0

The surveys indicate that business and convention demand, the two market segments to be impacted by the current tax proposal, comprise the major proportion of business volume in the lodging industry, ranging from 56 to 69 percent of the total.

From an economic perspective, the financial performance of the industry as a whole has not been good. Because of the labor and capital intensiveness of the industry, break-even is rather high at an estimated level of 59 percent occupancy. The profitability of the industry recently has been eroded by severe increases in labor and energy expenses. The net effect, based on the aggregate balance sheet and income statement, is an average return on invested capital of only 5.5 percent, well below the return expected by most investors in a high risk industry.

It may be concluded that since the industry is currently experiencing a low return on capital and has an inherently high break-even point that any factor which acts to reduce revenues will bring the industry even closer to the break-even point. This would mean even a lower return on capital, more difficulty in attracting capital, a slowdown of the industry's growth and therefore, a loss of jobs. This could mean that certain operations may be threatened by foreclosure and closing resulting in an immediate loss of jobs beyond the national reduction in employment due to reduced revenue as a result of the Administration's proposal.

We estimate that in 1977, revenue from the sale of guest rooms in the lodging industry was $10.1 billion, revenue from the sale of food and beverages was $4.7 billion and industry employment was 860,000. Based on this information, the resultant tax reform impact could be a decline of $911.2 million in rooms revenue, $806.5 million in food and beverage revenue, $205.8 million in other revenue and 60,200 jobs.

Impact on industries providing goods and services to the lodging industry

The total equivalent secondary employment generated by the lodging industry in 1977 was 251,050 or approximately 1 for every 3.5 persons employed in hotels, motels and motor hotels. The net loss in employment as a result of the tax revisions could range from 8 to 12 percent or from 20,100 to 30,100 persons. In our estimation, the nature of the industries providing goods and services to hotels, motels and motor hotels, is such that this loss would not be offset by an increase in jobs generated from additional consumer spending in the lodging industry, if any, that might result from the other tax reform proposals primarily because these industries are dependent on commercial spending and not retail or consumer spending.

Conclusions

The possible impact of legislation as shown in this study to date can be conservatively measured as follows:

Loss of revenue in 1978	$1,920,000,000
Reduction of employment:	
Direct	60,000–93,000
Indirect	20,000–30,000

II LODGING INDUSTRY POSITION

Nowhere in the Treasury's "detailed" descriptions is there an analysis of non-compliance with present law. In fact, the IRS is not even asking for information on corporate entertainment, travel, and business gifts until the filing of calendar year 1978 tax returns. There is just a vague and unsupported assertion that the Administration perceives this part of the tax law to be unfair, elitist, and unnecessary as it provides "personal benefits and personal enjoyment" to the recipient.

Treasury appears to be insensitive as to how the business community itself is treating this area of expense. The Treasury is obviously unaware of the increasingly strict internal controls most companies have put on their employees' use of business expense accounts. Since companies attempt to maximize profits, it is in their own best interests to limit abuses in this area.

So, while it is clear the Treasury is against personal enjoyment, and large numbers of people at lunches, we have no new policy statements, no careful analyses of abuses—no supporting data, and no fair and balanced attitude in their approach to this issue. This is their attempt to shape the society through the tax system and by bureaucratic fiat.

Jobs

The Treasury estimates that business deducted $3.4 billion during 1976 for food and beverage entertainment.

The Treasury has admitted that jobs will be lost in the food service industry. Secretary Blumenthal has said that 50,000 to 70,000 jobs, *or* two to three percent of the jobs in the industry will be *lost*. Yet the Bureau of Labor Statistics states that in 1977 there were about four million food service employees; a two to three percent loss of jobs equals about 76,000 to 114,000 jobs. Yet, the study conducted for us by the accounting firms reveals that there will be a significant job loss in the *lodging industry alone*. While Treasury already admits the loss of around 100,000 jobs in the entire food service industry—a figure bad enough in itself—we disagree with that and estimate a 92,900 job loss in the hotel/motel industry. These are *lost* jobs, not jobs affected, not hours lessened, more days off, etc. Treasury has emphasized the least possible effect on our industry, not the most probable effect. In addition, we predict a loss of about 25,000 in those industries providing goods and services to the ladging industry.

Revenue

Treasury claims that it will gain approximately $1.195 billion in revenue by 1979 as a result of these business entertainment propósals. This again is the absolute maximum that could possibly be gained by the most liberal interpretation of statistics. The Treasury assumes in reaching that figure that the disallowance of a tax deduction for 50 percent of business meals would have no adverse impact on spending by the companies or individuals who presently incur such expenses. They will continue to spend the same total dollars, but there will be a shifting of those dollars from business advertising. Additionally, these new areas of expenditures do not traditionally generate as much employment as does our industry. Our own study mentioned earlier in the testimony, predicts a decline of $911 million in rooms revenue and $806.5 million in food and beverage revenue.

ADDITIONAL SUMMARY STATEMENT OF THE HOTEL/MOTEL INDUSTRY POSITION

A business meal stretches the amount of time a businessman can work during the day; it is the ninth hour of work.

Hotels, motels, and restaurants have come to depend upon, indeed, many have been built up around this allowable deduction that has been in tax laws for many, many years (since 1939).

We reiterate that this would hurt available jobs in our industry. If 1962 and 1963 are any indication (when the Congress changed the law and required substantiation of certain business entertainment expenses, it hurt the food service industry in many cities—some restaurants even closed) many restaurants and hotels will lose considerable business. Some will go under and many of our employees will be laid off. We employ large numbers of minority workers, workers who are non-skilled.

France, Japan, England, West Germany, Italy to name a few, have expense account allowances in their tax laws. The American businessmen will be at a competitive disadvantage.

State and local room, meal and sales taxes will be reduced considerably if expense account business is lessened.

These proposals could have a devastating impact on major urban area; witnesses from New York City and Washington will be testifying as to the exact adverse impact.

Treasury revenue gains will not equal revenue losses due to reduced income from lost jobs; employees on unemployment, and/or welfare; in addition, the creation of new jobs by public funds is expensive to the government.

Foreign conventions

Basically, we favor repeal of Section 274(h) of the Code and feel that expenses incurred in attending foreign conventions should be subject to the ordinary and necessary rules for business deductions.

The law should have been focused upon the vacation disguised as a business trip and not on all legitimate conventions that take place overseas.

If the law is not repealed, then we feel that any changes in the law should include the following areas:

1. Per diem limitation should be repealed or modified.
2. Definition of foreign convention; not include normal business meeting.
3. Exempt countries within North America including the Caribbean from any convention restrictions.
4. Reporting requirements should be made more practical and reasonable.

First class air fare

Treasury's embracing a government intervention mentality which allows for judgements as to what is luxurious and what is not. It is a short step from this to deciding that a taxi from an airport to the center of a city is a luxury when buses or trains are available, or that certain hotel rooms are more luxurious than others, certain type restaurants more capitalist/decadent than others, and so on. We oppose the limitation on tax deduction for first class air fare.

Depreciation methods

If the Administration is in favor of capital formation, then this proposed disallowance of accelerated depreciation on buildings together with a limitation on the amount of write-down to the taxpayer's equity is completely inconsistent with their goals.

We do feel that Treasury should change the current law, but in an opposite manner. If business is expected to invest in our economy, it must be encouraged to do so by allowing as quick a capital recovery as possible, so that the true value of the recovery is not eaten into by inflation.

Investment tax credit

We would urge the Committee to extend the new broader applicability of the investment tax credit to hotel and motel construction or rehabilitation as H.R. 13511 has done (Section 314).

The hotel and motel business is a very capital intensive industry investing huge amounts in their plants. This investment is not a passive investment; it is an operating physical asset that is currently being excluded from the tax relief the Administration is proposing for industrial and utility structures.

At risk provisions

H.R. 13511 clarifies the law as to whether or not the owning and operating of a hotel or motel is the holding of real property under the "at risk" rules. The House report clearly states that this type of activity comes under the real estate exception of the "at risk" provisions. We support these sections (201–204) of the House bill and we support this clarification of the law.

STATEMENT

The American Hotel and Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands, having a membership of approximately 7,000 hotels and motels representing about 925,425 rooms. The total of employees directly employed in our industry is approximately 860,000. The industry has an annual payroll and related expenses of 5.7 billion, of which 1.8 billion is related to food and beverage revenue.

The major purpose of my testimony today is to comment on the Administration's tax proposals that would disallow as a tax deduction 50 percent of business meals on non-travel status. We will also comment on other areas of tax reform that will affect our industry; such as curtailments of tax deductions for first class airfare and foreign conventions. Additionally, we will state our position on the proposals for the investment tax credit, and depreciation methods.

The proposals to curtail tax deductions for business expenses goes right to the heart of our business. Approximately 60 percent, and in some centercity hotels over 70 percent of our overall business comes from the patronage of businessmen.

We would like to first outline for you our analysis of how the business expense account presently affects our industry, and how that will change if these proposals become law. This statistical analysis is from a recent study conducted for the American Hotel and Motel Association by two respected national accounting firms, Laventhol and Horwath, and Harris, Kerr, Forster and Company.

Secondly, we would then like to discuss the industry position as to why we oppose these proposals.

I. ACCOUNTING FIRM STUDY

The following are some extrapolations from the recent study conducted for the American Hotel and Motel Association by the above-mentioned accounting firms.

Scope of study

The Administration originally proposed to limit the deduction for ordinary and necessary business meals to 50 percent of their cost. A later interpretation of that proposal by government representatives implies that only business meals of those persons not on "travel status" would be affected. The implications of proposed restrictions on ordinary and necessary business expenses and the impact on revenue and employment in the lodging industry regardless of how it is cloaked, could be severe.

This preliminary report includes information concerning the size and economic status of the industry, and the results of our analysis of the returns available from an industry survey designed to obtain information from operators of lodging facilities as to the probable impact of the tax reform on their operations. It also includes information concerning the industries that provide goods and services to the lodging industry and we have estimated the probable impact on these industries, based upon preliminary analysis of the lodging industry survey results.

Industry background

As of December 31, 1977, an estimated 40,000 to 45,000 lodging establishments were operating in the United States. The scope of these operations range from the 10-room "Mom and Pop" owned and operated facilities to the over 1,000-room corporate owned and operated hotels. These facilities consisting of both year round and seasonal operations, provide a daily capacity of 2,500,000 available rooms.

The average sized operation ranges from approximately 50 to 60 rooms. However, although hotels and motels of 100 rooms or more comprise only approximately 12 percent of the total number of industry operations, they represent approximately 48 percent of the total number of available guest rooms in the industry, generate approximately 68 percent of total industry employment. It may be concluded that the lodging industry today is typified by the larger properties which, in turn, are predominantly owned, managed or affiliated with a hotel or motel chain. It has been estimated that approximately 29 percent of the total number of U.S. properties and approximately 63 percent of the total number of the available guest rooms in 1977 are represented by chain operations.

Annual average occupancy for the industry in 1977 is estimated at approximately 68 percent for properties operating year round or at 62 percent if seasonal operations are included.

It is further estimated that approximately 860,000 people were employed in the lodging industry in 1977 on either a full or a part-time basis. It is worthwhile to note that the lodging industry is a large employer of unskilled labor (who are also traditionally the largest group on the unemployment roles) as shown by the following labor mix:

	Percent
Professional workers	2.4
Managers, officials and proprietors	15.2
Salesworkers	.3
Clerical workers	16.9
Craft and kindred workers	2.9
Operatives and kindred workers	2.3
Service workers	59.1
Non-farm workers	.9
Total	100.0

Demand for lodging, food and beverage, and ancillary facilities may be segregated into business and convention, tourist and "other" market segments. Demand in 1977 emanating from these market segments was estimated as follows:

[In percent]

	L&H lodging industry study	L&H chain survey	HKF chain survey
Business and convention	64	69	62
Tourist	34	29	38
Other	2	2	
Total	100	100	100

Exhibit A on the following page presents the preliminary Phase I results of the industry survey regarding source of rooms, food and beverage demand, segregated into various categories. Each of these four surveys indicate that business and convention demand, the two market segments to be impacted by the current tax proposal, comprise the major proportion of business volume in the lodging industry, ranging from 56 to 69 percent of the total, as indicated above and on the following pages.

From an economic perspective, the financial performance of the industry as a whole has not been good. Exhibit B, page 7, presents the aggregate balance sheet and Exhibit C, page 8, presents the aggregate income statement for the industry in 1977. Because of the labor and capital intensiveness of the industry, break-even is rather high at an estimated level of 59 percent occupancy. The profitability of the industry recently has been eroded by severe increases in labor and energy expenses. The net effect, based on the aggregate balance sheet and income statement, is an average return on invested capital of only 5.5 percent, well below the return expected by most investors in a high risk industry.

INDUSTRY SURVEY: WEIGHTED—MEAN OF RESPONSES

[In percent]

Segment	Total	Hotel	Motor hotel	Affiliation: Chain owned/managed	Managed only	Independent
Percent of room revenue from:						
Business and convention	56.2	61.1	53.6	70.6	67.6	47.2
Tourist	39.6	21.9	43.4	24.6	28.5	48.6
Other	4.2	7.0	3.0	4.8	3.9	4.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
Percent of food and beverage revenue from:						
Business and convention	57.5	61.8	53.7	72.0	64.9	45.9
Tourist	36.2	29.7	41.3	21.8	29.9	46.4
Other	6.3	8.5	5.0	6.2	5.2	7.8
Total	100.0	100.0	100.0	100.0	100.0	100.1

Segment	Location: Center City	Airport	Suburban	Highway	Resort	Number of rooms: Under 100	100 to 299	300 to 500	Over 500
Percent of room revenue from—									
Business and convention	59.7	73.8	66.8	52.2	29.8	44.9	63.6	72.4	75.6
Tourist	33.4	16.6	29.7	44.6	96.1	52.7	31.1	21.7	15.4
Other	7.0	9.6	3.5	3.2	1.1	2.4	5.4	5.9	9.0
Total	100.1	100.0	100.0	100.0	100.0	100.0	100.1	100.0	100.0
Percent of food and beverage revenue from—									
Business and convention	59.1	69.9	68.2	56.7	32.6	37.6	62.7	69.2	79.9
Tourist	31.3	23.3	29.8	34.8	65.0	58.3	30.5	23.2	10.9
Other	9.7	6.8	3.0	8.6	2.4	4.2	6.7	7.6	9.2
Total	100.1	100.0	100.0	100.1	100.0	100.1	99.9	100.0	100.0

THE LODGING INDUSTRY PRO FORMA BALANCE SHEET, CALENDAR YEAR 1977

[Dollar amounts in thousands]

	Amount	Ratio to total assets (percent)	Ratio to total sales (percent)
ASSETS			
Current assets:			
Cash	$1,153	6.7	6.9
Accounts receivable (net)	698	4.1	4.2
Inventories	218	1.3	1.3
Other	300	1.7	1.8
Total current assets	2,369	13.8	14.2
Fixed assets:			
Land, building, furniture and equipment	24,477	142.5	147.1
Less accumulated depreciation	10,930	63.6	65.7
Net book value	13,547	78.9	81.4
Other assets	1,264	7.3	7.6
Total assets	17,180	100.0	03.2
LIABILITIES AND EQUITY			
Current liabilities:			
Notes payable	$819	4.8	4.9
Accounts payable and accrued expenses	1,666	9.7	10.0
Current portion of long-term debt	788	4.6	4.8
Total current liabilities	3,273	19.1	19.7
Long-term debt	10,210	59.4	61.3
Total liabilities	13,483	78.5	81.0
Equity	3,697	21.5	22.2
Total liabilities and equity	17,180	100.0	103.2

Source: U.S. Department of Commerce—1972 Census of Business, Monthly Selected Services Receipts; Department of the Treasury—Statistics of Income, 1974; Department of Labor—Employment and Earnings; Robert Morris Associates—Annual Statement Studies, 1977; Laventhol & Horwath—U.S. Lodging Industry, 1977 and Laventhol & Horwath Estimates.

THE LODGING INDUSTRY—PRO FORMA INCOME STATEMENT, CALENDAR YEAR 1977

	Amount (thousands)	Ratio to sales (percent)
Revenues:		
Rooms	$10,124.2	60.8
Food and beverage	4,744.1	28.5
Other	1,775.7	10.7
Total	16,644.0	100.0
Operating expenses:		
Cost of sales	1,666.6	10.0
Payroll and related expenses	5,659.6	34.0
Other	5,169.0	31.1
Total	12,495.2	75.1
Income before fixed charges	4,148.8	24.9
Rent, property taxes, and insurance	2,053.6	12.3
Income before interest and depreciation	2,095.2	12.6
Interest	879.8	5.3
Income before depreciation	1,215.4	7.3
Depreciation	1,065.7	6.4
Income before income taxes	149.7	.9
Income taxes (based on 55 percent of properties reporting taxable income)	219.7	1.3
Net loss	(70.0)	(.4)

Source: U.S. Department of Commerce, 1972 Census of Business, Monthly Selected Services Receipts; Department of the Treasury, Statistics of Income, 1974; Department of Labor, Employment and Earnings; Robert Morris Associates, Annual Statement Studies, 1977; Laventhol & Horwath, U.S. Lodging Industry, 1977, and Laventhol & Horwath estimates.

It may be concluded that since the industry is currently experiencing a low return on capital and has an inherently high break-even point, that any factor which acts to reduce revenues will bring the industry even closer to the break-even point. This would mean even a lower return on capital, more difficulty in attracting capital, a slowdown of the industry's growth and therefore, a loss of jobs. This could mean, as we will discuss later, that certain operations may be threatened by foreclosure and closing resulting in an immediate loss of jobs beyound the national reduction in employment due to reduced revenue as a result of the Administration's proposal.

Survey methodology

A survey was designed specifically to determine the projected impact of the proposed tax revision on the lodging industry. The sample size and composition was developed to represent the industry as a whole and a sample was selected, appropriately segregated by chain or independent management, size of the property and by geographic location.

Subsequent to the distribution of this questionnaire it was determined that the Administration's proposal may be applied only to those deductions incurred by those who are on "non-travel" status. Accordingly, we conducted a telephone survey of approximately 25 percent of the questionnaire respondents for purposes of verification and to determine how their original responses may have differed if the tax proposal is limited to those on "on-travel" status. This procedure indicated no appreciable change to the results of our questionnaire survey.

The major conclusions of the analyses are presented in the following pages.

Direct industry impact

The survey results indicate that rooms revenue, food and beverage revenue and employment would decline if the Administration's tax proposal is legislated. If the tax law is not changed, the survey results indicate that rooms revenue and food and beverage revenue would increase while employment would remain unchanged. Accordingly, the projected impact is as follows:

[In percent]

	Projected impact of tax proposal (median)	Projected industry performance if no change in tax law (median)	Combined effective decline
Rooms revenue	−2	+7	−7
Food and beverage revenue	−10	+7	−19
Employment	−7	0	−7

We estimate that in 1977, revenue from the sale of guest rooms in the lodging industry was $10.1 billion, revenue from the sale of food and beverages was $4.7 billion and industry employment was 860,000. Based on this information, the resultant tax reform impact could be a decline of $911.2 million in rooms revenue, $806.5 million in food and beverage revenue, $205.8 million in other revenue and 60,200 jobs.

If the decline in industry employment is only 7 percent as a result of the projected greater drop in industry revenue as previously noted, there will be a decline of more than 4 percent in output per employee. This reduction in employee productivity would further aggravate an already serious lack of profits in the industry. Since it is unlikely that operators would be able to absorb a drop in productivity of that magnitude, we project that total employment may decline by 92,900 employees.

It is significant that of the estimated loss of 92,900 jobs, approximately 80 percent or 74,300 jobs would be among lower rated service employees who are comprised predominately of unskilled workers, minorities and ethnic groups.

Based upon the survey, it is apparent that virtually all types and sizes of lodging facilities would be affected by the proposed legislation; those which would be primarily impacted comprise establishments of 500 guest rooms or

more. These properties typically are located in large urban areas. The survey results for such establishments are as follows:

[In percent]

	Projected impact of tax proposal (median)	Projected industy performance if no change in tax law (median)	Combined effective decline
Rooms revenue	−15	+8	−23
Food and beverage revenue	−16	+8	−24
Employment	−14	+3	−17

Impact on industries providing goods and services to the lodging industry

We estimate that the lodging industry spent $10.6 billion in 1977 for goods and services, including municipal, state and federal services. Based upon the Input-Output Structure of the U.S. Economy: 1976, published by the U.S. Department of Commerce, and information from that department's monthly report on the Survey of Current Business, reports by the Office of Economic Growth of the Bureau of Labor Statistics and annual studies of the lodging industry by Laventhol & Horwarth, we have analyzed the expected impact on those industries that sold goods and services to the lodging industry in 1977. Included in the analysis is the computation, by industry, of total employment generated by the expenditures of the lodging industry.

Excluding those industries for which data are unavailable, and the government agencies in which employment is apparently unaffected by changes in revenue, the total equivalent secondary employment generated by the lodging industry in 1977 was 251,050 or approximately 1 for every 3.5 persons employed in hotels, motels and motor hotels.

The analysis of the preliminary results of the industry survey indicate the following:

TOTAL ANNUAL PURCHASES OF GOODS AND SERVICES BY THE LODGING INDUSTRY

[In percent]

If tax law is changed as proposed	−4
If no change in tax law	+6
Combined impact	−10

Based upon the preceding reduction in lodging purchases, the net loss in employment as a result of the tax revision could range from 8 to 12 percent or from 20,100 to 30,100 persons. In our estimation, the nature of the industries providing goods and services to hotels, motels and motor hotels, is such that this loss would not be offset by an increase in jobs generated from additional consumer spending in the lodging industry, if any, that might result from the other tax reform proposals primarily because these industries are dependent on commercial spending and not retail or consumer spending. The actual employment impact experienced would depend on such factors as the success of related industry attempts to shift sales efforts to other sources of demand and improved cost controls in areas other than payroll.

It should be noted that this analysis has not included any projection of the so-called "multiplier effect" on other industries such as the airlines and local public transportation. Further, we have not incorporated the economic effect of reduced spending resulting from the displacement of employees in the lodging industry and the suppliers of good and services to this industry. We also have not quantified the loss of tax revenue at the state and municipal level due to reduced sales taxes, for example, that would result from any decline in lodging and related expenditures. As a result, therefore, the potential total economic effect of the Administration's tax proposal is considerably greater than the impact noted herein.

CONCLUSIONS

The lodging industry is capital and labor-intensive and a major employer of unskilled and minority workers. Already threatened with severe problems because

of compliance with government regulations, the increasing costs of energy, and substantial increases in minimum wages and payroll taxes, the lodging industry is now faced with a severe loss of revenue because of the proposed restriction on the deduction for tax purposes of ordinary and necessary business expenses. The industry, nationally, depends upon business and convention sources for between 56 to 69 percent of its volume. In fact, for certain types of markets, that ratio approaches 80 percent.

The possible impact of legislation as shown in this study to date can be conservatively measured as follows:

Loss of revenue in 1978	$1,920,000,000
Reduction of employment:	
Direct	60,000–93,000
Indirect	20,000–30,000

II. LODGING INDUSTRY POSITION

The President has proposed that:

1. Deductions for business meals be limited to 50 percent of the cost of meals now consumed by those on non-travel status and currently allowed as a business expense.

2. Deductions for attending foreign conventions allowed only if it is as reasonable to hold the convention outside the United States and its possessions as within.

3. Deductions be disallowed for the difference in airfare attributable to first class and coach.

4. Deductions be totally disallowed for entertainment facilities such as yachts, hunting lodges, and club dues.

5. Deductions be totally disallowed for entertainment activities, such as the cost of tickets to theatre and sports events.

The Treasury Department's "detailed descriptions and supporting analyses" of President Carter's proposals are replete with anecdotes detailing the gross abuses of a few individual taxpayers. Their point is, as Secretary Blumenthal admitted before this Committee on January 30, 1978, that the law is difficult if not impossible to enforce. Treasury failed to say that the examples cited were uncovered by them under existing regulations and reporting. Their solution of allowing only a 50 percent deduction is put forward as a wise approach to the problem yet the Secretary admitted, on the same day, that this 50 percent is an "arbitrary" figure.

Nowhere in the Treasury's "detailed" descriptions is there an anaylses of noncompliance with present law. In fact, the IRS is not even asking for information on corporate entertainment, travel, and business gifts until the filing of calendar year 1978 tax returns which will not be due until March 15, 1979 at the earliest. There is just a vague and unsupported assertion that the Administration perceives this part of the tax law to be unfair, elitist, and unnecessary as it provides "personal benefits and personal enjoyment" to the recipient.

The present law states that "ordinary and necessary" business expenses are deductible and we agree that that is an adequate general statement of what should and should not be allowed. The law specifically states that "lavish or extravagant" meals and lodging expenses are not deductible. Thus, the clear intention of Congress, and of the law as it already exists, conforms with the Treasury's position that extraordinary and unnecessary business expenses should not be deductible. The problem is not in the law but is in the application of the language to actual business practices.

Much of Treasury's rationale in the present proposals relates to the "ordinary and necessary" test, saying that it imposes relatively few restrictions and is too vague and too subjective a standard to really hinder any abuses. The Treasury in its lively anecdotes about a few free spending taxpayers talks about how the reporting and substantiating requirements are inadequate and how the language "directly related" or, "associated with" is too liberal. (Entertainment expenses to be deductible under present law must, among other things, be "directly related" to or "associated with" the taxpayer's business). Yet this language is from their own regulations issued by the IRS in 1962 and 1963.

In 1961 and 1962 Congress enacted new travel and entertainment legislation (Code section 274) which had two principal goals:

1. To deny deductions based on estimations and uncorroborated statements of taxpayers, and

2. To deny deductions for items which are essentially social or living expenses.

The present regulations were adopted by the IRS in response to that legislation. At that time, the Commissioner of IRS commented on how the regulations were drafted:

"In preparing regulations under the new statute, Internal Revenue did not work in an ivory tower.

In the first instance, we meticulously sought to follow the direction of Congress. This was emphasized to our staff members who were charged with the responsibility of drafting the various provisions of the regulations . . .

Next, our policy guideline was clearly fixed so as to apply a rule of reason and to attain a balance set of regulations. We did not want the statute or regulations to interfere with legitimate business activity. Our aim was only to end abuses identified by the Congress. Both during and after the drafting state, we conferred with many business and professional leaders to get their ideas and suggestions, and to work together with them in solving various practical problems. In addition, numerous business expense account forms and practices were carefully studied.

Tentative regulations were then reviewed by my advisory group of outstanding lawyers, accountants and businessmen. Finally, the public comments were invited and public hearings were scheduled to obtain taxpayer reactions."

Yet in the present proposals the Treasury is living in an ivory tower. The solution is not an arbitrary limit on all taxpayers but better control of the taxpayers who abuse expense accounts.

Treasury appears to be insensitive as to how the business community itself is treating this area of expense. The Treasury is obviously unaware of the increasingly strict internal controls most companies have put on their employees' use of business expense accounts. Since companies attempt to maximize profits, it is in their own best interests to limit abuses in this area. Treasury has failed to see that business is as opposed to these abuses as they are. Treaury's reasoning seems to be abstract and unknowledgeable about the business world. For example, some of the reasons that the Treasury and the Administration used in justifying their proposals are:

"The probability of the luncheon being truly business meal usually decreases as the number of people increases".

In relation to the deduction of first class airfare, they said, ". . . Both ends of the plane arrive at the time time!"

The publicity for the proposals never fails to mention the three-martini lunch—which is a total myth as my colleagues in the restaurant industry have shown.

". . . entertainment provided for business reasons must produce personal enjoyment in order to have its intended effect."

So, while it is clear the Treasury is against personal enjoyment, and large numbers of people at lunches, we have no new policy statements, no careful analyses of abuses—no supporting data, and no fair and balanced attitude in their approach to this issue. This is their attempt to shape the society through the tax system and by bureaucratic fiat.

Jobs

The Treasury estimates that business deducted $3.4 billion during 1976 for food and beverage entertainment. This expenditure equals 5.5 percent of 1976 business receipts of food service establishments, including those located in and run by hotels, motels and other commercial lodging places, and separate eating and drinking places.

The Treasury has admitted that jobs will be lost in the food service industry. Secretary Blumenthal has said that 50 to 70,000 jobs, or two to three percent of the jobs in the industry will be lost. Yet the Bureau of Labor Statistics states that in 1977 there were about four million food service employees; a two to three percent loss of jobs equals about 76,000 to 114,000 jobs. Yet, as quoted in the earlier part of this testimony, the study conducted for us by the accounting firms reveals that there will be a significant job loss in the lodging industry alone. While Treasury already admits the loss of around 100,000 jobs in the entire food service industry—a figure bad enough in itself—we disagree with that and estimate a 92,900 job loss in the hotel/motel industry. These are lost jobs, not jobs affected, not hours lessened, more days off, etc. Treasury has emphasized the least possible effect on our industry, not the most probable effect.

Treasury says that "rapid employment turnover in our industry will absorb

much of any employment reduction." The turnover rate the Treasury refers to is the result of employees who quit one hotel to work for another, quit one restaurant to work for another, and move from one city to another. We disagree with Treasury's comment that our turnover will absorb our employment reduction. There will be a permanent loss in the number of jobs in our industry; and those that lose jobs have learned special skills unique to our industry and generally not easily transferable to other fields.

So, in summary, using the Treasury's statistics it seems clear that in the food service industry alone there will be at least 75 to 100,000 jobs lost. Our figures, as we stated, are much higher. We see, to reiterate a loss of 92,900 jobs in just the hotel/motel industry. In addition, we predict a loss of about 25,000 jobs in those industries providing goods and services to the lodging industry. If the above is true, it seems that the Treasury must have stronger arguments for insisting on this type of tax proposal which is contradictory to the Humphrey/Hawkins and other bills that are trying to create jobs. Even the Labor Department is presently spending money for job training programs for waiters, waitresses, cooks, chefs, etc.

Revenue

Treasury claims that it will gain approximately $1.195 billion in revenue by 1979 as a result of these business entertainment proposals. This again is the absolute maximum that could possibly be gained by the most liberal interpretation of statistics. The Treasury assumes, in reaching that figure that the disallowance of a tax deduction for 50 percent of business meals would have no adverse impact on spending by the companies or individuals who presently incur such expenses. It assumes that they will spend just as before, even though that type of expenditure will cost the business more in after-tax dollars. But, companies will not spend exactly as before. They will continue to spend the same total dollars, but there will be a shifting of those dollars from business meals into other tax deductible expenditures such as business advertising. Additionally, these new areas of expenditures do not traditionally generate as much employment as does our industry.

If the employment loss is approximately 100,000 jobs with an estimated average salary of $6,000 there would be loss of revenue and taxable income therein to the Treasury of $600,000,000. Our own study mentioned earlier in the testimony, predicts a decline of $911 million in rooms revenue and $806.5 million in food and beverage revenue.

The Treasury has never said that a business meal deduction is unnecessary to business operations. They realize that, tax deductible or not, the practice will continue. What they are proposing is not outlawing business meals, but arbitrarily making it more expensive for a company to continue to spend money in this way. The Treasury is not clear as to whether they oppose business meals as a tax deduction, or whether they oppose the *abuse* of legitimate business meal deductions. If 50 percent of the business meal is disallowed and if business—such as a manufacturer—decides that the business meal is still a necessary expenditure, then the manufacturer will have to raise their prices to the ultimate consumer to cover this additional cost. This seems directly opposed to the Administration's efforts to control inflation.

Additional summary statement of the hotel/motel industry position

The reasons we believe that business entertainment expenses, particularly the business meal, should continue to be fully deductible are many and we have stated the major ones but let me briefly summarize a few more:

"A business meal stretches the amount of time a businessman can work during the day; it is the ninth hour of work.

"Hotels, motels, and restaurants have come to depend upon, indeed, many have been built up around this allowable deduction that has been in tax laws for many many years (since 1939).

"We reiterate that this would hurt available jobs in our industry. If 1962 and 1963 are any indication (when the Congress changed the law and required substantiation of certain business entertainment expenses, it hurt the food service industry in many cities—some restaurants even closed) many restaurants and hotels will lose considerable business. Some will go under and many of our employees will be laid off. We employ large numbers of minority workers, workers who are non-skilled. Using the Treasury's own generously interpreted statistics, approximately 100,000 jobs will be lost in the food service industry.

"France, Japan, England, West Germany, Italy to name a few, have expense account allowances in their tax laws. The American businessmen will be at a competitive disadvantage.

"State and local room, meal and sales taxes will be reduced considerably if expense account business is lessened.

"The proposals could have a devastating impact on major urban areas; witnesses from New York City and Washington will be testifying as to the exact adverse impact.

"Treasury revenue gains will not equal revenue losses due to reduced income from lost jobs; employees on unemployment, and/or welfare; in addition, the creation of new jobs by public funds is expensive to the government."

Foreign conventions

Section 274(h) of the Internal Revenue Code limits the amount of tax deductions that can be taken by an individual or corporation on a business convention overseas.

The Administration, recognizing that this foreign convention problem was not solved by the Tax Reform Act of 1976 has presented proposals to change that law. Generally, the President proposes that the expenses of attending a foreign convention be deductible only if it is as reasonable to hold the convention outside the United States and its possessions as within.

Basically, we favor repeal of Section 274(h) of the Code and feel that expenses incurred in attending foreign conventions should be subject to the ordinary and necessary rules for business deductions.

The law should have been focused upon the vacation disguised as a business trip and not on all legitimate conventions that take place overseas. The law has had a serious economic impact on many United States hotel corporations who have properties outside the United States.

If the law is not repealed, then we feel that any changes in the laws should include the following areas:

"Per diem limitation should be repealed or modified.

"Definition of foreign convention; not include normal business meeting.

"Exempt countries within North America including the Caribbean from any convention restrictions.

"Reporting requirements should be made more practical and reasonable.

First class air fare

Under present law transportation expenses may be deductible if incurred in connection with the taxpayer's travel away from home on business. First class airfare generally is deductible (except in attending a foreign convention). The Treasury feels that this is a luxury. They state: "The primary difference between a first class seat and a coach seat on an airplane is personal indulgence."

Their reasoning is more simplistic in this area than in the others. They are embracing a government intervention mentality which allows for judgments as to what is luxurious and what is not. It is a short step from this to deciding that a taxi from an airport to the center of a city is a luxury when buses or trains are available, or that certain hotel rooms are more luxurious than others, certain type restaurants more capitalist/decadent than others, and so on.

They tamper with far reaching tax and economic policies unembarassed by research or inquiries into opposing points of view; they shift and shape tax proposals around experimentally until the social canvas looks right to them. Job losses, industry profits, disrupted businesses and all the other effects of changes in the law are all dismissed by Treasury as insignificant and unavoidable consequences. Even the mere announcement of these proposals changes business attitudes, investment decisions, corporate planning.

The Treasury estimates that they will gain $21 million in revenue by disallowing as a deduction the difference for first class air travel. That amount is approximately half of the total airline profits. The U.S. Travel Data Center estimates that such a proposal could jeopardize about 9,000 jobs.

Depreciation methods

Treasury proposes to limit the depreciation method used on buildings to straight line and temporarily limit the amount of write-down to the taxpayers' equity. After the conclusion of a proposed three-year study, Treasury would publish findings on the decline in value of a typical building over a 10 or 20 year period. The taxpayer would then have the option of either depreciating a building down to their equity in it or using the guideline published by the Treasury.

Treasury has not focused on one of the primary reasons accelerated depreciation was initially allowed: to encouragement capital formation.

If the Administration is in favor of capital formation, then this proposed disallowance of accelerated depreciation on buildings together with a limitation on the amount of write-down to the taxpayer's equity is completely inconsistent with their goals.

We do feel that Treasury should change the current law, but in an opposite manner. If business is expected to invest in our economy, it must be encouraged to do so by allowing as quick a capital recovery as possible, so that the true value of the recovery is not eaten into by inflation. The quicker the recovery of investment, the quicker it can and will be reinvested in the economy.

Investment tax credit

The Administration's in its proposals correctly addresses the need to stimulate business investment. They cite the need to remove the impediments of current tax law that favor certain investments over others and they propose to extend the Investment Tax Credit to construction or rehabilitation of industrial and utility structures.

We would urge your Committee to extend the new broader applicability of the investment tax credit to hotel and motel construction or rehabilitation as the House bill does.

The hotel and motel business is a very capital intensive industry investing huge amounts in their plants. This investment is not a passive investment; it is an operating physical asset that is currently being excluded from the tax relief the Administration is proposing for industrial and utility structures.

Additionally, the administration is further weakening the tax treatment currently afforded investments in real estate by proposing to eliminate all accelerated methods of depreciating the structures,—the adverse impact of this proposal is discussed later in the text.

We urge your Committee to equalize the tax benefits currently enjoyed by other capital intensive industries and to expand the Administrations' proposal to include the hotels and motels as structures qualifying for the investment tax credit.

At risk provisions

Under the House bill (Sections 201–204) the "at risk" loss restriction limitation of present law would be extended to apply to all activities except real estate—and hotels and motels are specifically included in this exception. The House Ways and Means Committee Report (95–1445) states: "For purposes of this (real estate) exclusion, personal property and services which are incidental to making real property available as living accommodations shall be treated as part of the activity of holding such real property. This exception is intended to exclude from application of the at risk rule situations where a taxpayer owns and operates a hotel or motel. In such instances, making available personal property such as furniture and services in conjunction with the renting of the hotel or motel room are to be considered incidental to making real property available as living accommodations. . ."

We would like this important provision to remain in the final bill since we believe that Congress clearly intended to have this type of activity included in the real estate exemption. This provision is really just a clarification of the law and not a new addition.

STATEMENT OF THOMAS W. POWER, GENERAL COUNSEL, FOODSERVICE AND LODGING INSTITUTE

Mr. Chairman and members of the Committee on Finance, thank you for giving us the opportunity to appear here today to present testimony on President Carter's tax proposals and also on provisions in Bill H.R. 13511, the Revenue Act of 1978, passed on August 10 by the House of Representatives.

I am Thomas W. Power, general counsel of the Foodservice and Lodging Institute, a trade industry group of thirty-five of the nation's major multi-unit and multi-state companies engaged in all facets of food service from the full service "white table cloth" restaurant to the vending machine. Our president, the Honorable William G. Stratton of Canteen Corporation, wanted to be here today but because of previous commitments, it was impossible. The members of our Insti-

tute own, operate or franchise more than forty thousand individual establishments, employ in excess of two million persons and account for gross sales of over $15.3 billion, one-sixth of the gross volume of the entire food service industry.

We request that our written statement be made part of the record of these proceedings and in the interest of time we will limit our oral presentation only to the highlights.

Accompanying me today and addressing two of our four principal issues is Mr. William Giery, executive secretary of the Institute. The four issues, in which our members share concern, are as follows:

1. Deletion of the President's proposal to limit the tax deductibility of expense account meals;
2. A provision in the Tax Reform Act dealing with employer reporting of tips charged by customers on credit cards;
3. The proposed jobs tax credit in Bill H.R. 13511; and
4. The proposed extension of the investment tax credit to rehabilitation of commercial buildings, including retail structures, incorporated in Bill H.R. 13511.

The business meals issue was just one small part of the President's original tax reform proposal. Fortunately, for all of us, the House Ways and Means Committee saw the economic implications of the President's proposal and after due consideration defeated all proposals to restrict the deductibility of business meals. I am sure that after these hearings are concluded, the Senate Finance Committee will do likewise. For the Administration's arguments are based on emotionalism while ours are based on practical reality. The distinguished chairman of this Committee understands the practical reality of a restriction on the deductibility of business meals. He has said that deductibility of business meals are to the businessman as fertilizer is to the farmer. It sweetens the deal and increases the yield. In New Orleans, which is a good convention city with some of the best restaurants in the world, the Superdome was built by money collected through the imposition of a hotel occupancy tax. Like Senator Long, there are mayors, governors and private businessmen across the country who are aware of the practical implications of the President's proposal. I am sure that, even in a simple country town like Plains, Georgia, which has experienced in recent years what could be considered a business boom, the mayor or city fathers would have some reservations about their favorite son's proposal now.

The President wants to control abuses of what he calls the "three martini lunch." It is a catchy phrase but attacking all expense account spending in order to put to a halt the few abuses the Internal Revenue Service has been able to come up with is akin to incarcerating all businessmen because statistics show an increase in white collar crime, or closing all banks to stop bank robberies. The ultimate solution may be reached but the method of achieving that solution is found wanting.

The entire history of the law of Torts is based on standards of reasonableness. In the Internal Revenue Code, we have placed limits on salaries to a reasonable amount, without stating a specific amount or percentage, to prevent the avoidance of personal income tax on dividends, we have placed limits on the retention of corporate earnings to an amount necessary to meet the reasonable needs of the business.

Now the Administration wants to substitute its judgment as to what is reasonable for the judgment of the taxpayer and because of this the proposal should fail. If the abuses of business meal spending is that wide-spread, and as businessmen we sincerely doubt it, it should be incumbent upon the Administration to attack the specific unreasonable abuses rather than proclaim a blanket restriction on the deductibility of all meals for business purposes.

Recently I read a report concerning a week-long talk between Secretary of State Cyrus Vance and Russia's Brezhnev. While the meeting was not too promising, the press did report that the luncheon sessions between the two were the most constructive sessions.

We believe that supporters of the business meals restrictions are under the assumption that an entertainment expenditure for business meals necessarily means an enjoyable personal experience to both the businessman picking up the tab and his business guest. This is just not factually correct. You, above anyone else as Senators, should know what a burden it actually is to entertain or be entertained through business meals. Many times a Senator receives four and five invitations to dinner or various functions on the same evening. What possible benefit can it be to a Senator to be the recipient of up to five dinners the same

evening, each and every evening, particularly when he would prefer to be at home with his family? We suggest that a more typical evening is like that of Senators, businessmen would prefer to eat at home. They entertain because it is the most expeditious way to accomplish their business objective.

To the extent that the taxpayer is treated unfairly, we believe that the system which relies on self-enforcement is undermined. Do we ask President Carter to pay from his own pocket the cost of entertaining heads of foreign nations? Should we require him to pay the difference between the cost of a tourist fare and the cost of operating Air Force One? Surely, this would be absurd. The nation realizes that costs of entertaining figures of state and of traveling in security are ordinary, necessary and reasonable expenses in connections with the performance of the Office of the President. But why should a different arbitrary rule apply to the citizens?

EXPENSE ACCOUNT RESTRICTIONS WOULD SIGNAL SEVERE LABOR CUTBACKS

We estimate that approximately $3.2 billion per annum is spent on business meals which are properly deductible as entertainment expenses. This is approximately comparable to the Treasury estimated revenue gain of $580 million to be achieved by disallowing one-half of the present entertainment expenses for business meals.

We do not assume that the disallowance of one-half of the deduction will result in the total elimination of the practice of entertaining clients or prospective customers through business meals. The U.S. Treasury itself admits employment loss is anticipated at 76,000 to 114,000. However, we believe that the disallowance will result in the elimination of as much as 300,000 jobs in our industry. Further, the impact of curtailed business entertaining will not be felt evenly on the nation's restaurants. Much of business entertainment is concentrated in a relatively small percentage of the nation's restaurants. For these restaurants whose collective sales volume amounts to approximately $10 billion annually, business entertaining represents an average of over 30 percent of their total sales.

This is a particular type of restaurant. Business patrons generally require an atmosphere conducive to the conduct of business. For the typical expense account restaurant, this means a table service restaurant with waiters and waitresses and a low customer turnover. The low turnover is attributable to the fact that businessmen want sufficient time to conclude their business discussion and/or sufficient time to create the business goodwill which is their purpose of the entertaining. As a result, the typical expense account restaurant may serve from one to two business meals in an evening per customer seat while the typical restaurant would serve three or four meals per customer seat. Thus, expense account restaurants have a much higher labor cost as a percentage of gross sales than do, for example, the typical fast food restaurant. Since the typical expense account restaurant calls for extra service, it is invariably an establishment where waiters and waitresses receive tips. We estimate that over 50 percent of the total expenditure for entertainment expenses in connection with restaurant meals goes directly to earnings of restaurant employees in expense account establishments through cash wages and tips.

Thus, patrons of expense account restaurants in which much of the business entertaining takes place, are directly responsible for more than $5 billion annually in remuneration to the employees of such establishments. No expense account restaurant can accept the substantial curtailment of its gross revenues which will occur if President Carter's proposal is enacted. Even a curtailment in sales as little as 10% will require significant adjustment in the operation of an expense account restaurant. The alternative is bankruptcy. The profit percentage of such restaurants is considerably less than 10% of gross revenue. In our estimate, no expense account restaurant will survive the curtailment of sales unless they drastically cut their labor costs as a percentage of sales. We predict that expense account restaurants will either close their doors or modify their operations so as to eliminate the higher labor costs now essential to the business meal clientele. As a result, they will eliminate service and curtail for their patrons the cost of tipping to the maximum extent possible. Expense account restaurants will have to reduce their labor costs as a percentage of sales from its present level of approximately 50%, including the cost of tipping, to the more realistic figure of 30%. If the restaurants presently accounting for $10 billion in sales are

to remain competitive, with the loss of business resulting from President Carter's proposal, they will in our judgment have to eliminate more than $2 billion per annum in the remuneration presently received by the employees of their establishments. This will mean the loss of more than 300,000 jobs in our industry.

We in the restaurant industry have had this experience before. In 1963, the Internal Revenue published in proposal form its regulations based on the 1962 changes in the tax laws relating to entertainment expense. Gross misunderstanding of the requirements of the new law had a devastating impact on restaurant sales. Thousands of restaurant businesses were in fact eliminated. Major cities—convention cities such as New York, Chicago, Los Angeles, San Francisco, and New Orleans—began almost immediately suffering the loss of much needed sales and occupancy tax revenues. In Chicago, restaurant business dropped 24 percent and over 1,000 waiters were laid off in a matter of days. A survey of 387 expense account restaurants in 70 major cities showed an average drop of 33 percent in business. In New York City, the Commerce Commissioner estimated that hotel and restaurant revenues would be $100 million lower that in the previous year. In Los Angeles, hotel owners reported a disastrous drop in convention attendance. One reported losing 7,780 convention room days. Only when the then Commissioner Mortimer Caplin made it clear to the business community that goodwill entertainment in the nation's restaurants were still permissible, did the sales of this segment of the industry begin to improve.

Compared with current expenditures this impact is minuscule. For example, figures released recently by the Chicago Convention and Tourism Bureau show that in Chicago alone, over $1 billion was spent in the hospitality industry on convention and tourism business in 1977.

REPORTING OF CHARGE ACCOUNT TIPS WILL BE AN ADMINISTRATIVE NIGHTMARE

A second issue we would like to address is a provision enacted as part of the 1976 Tax Reform Act (Section 1312 of the Act amending Sections 6001 and 6051 of the Code) regarding employers' duties to report charge account tips of employees to the Internal Revenue Service.

Unless there is some modification enacted by this Congress, beginning on January 1, 1979 employers will be required to report to IRS all tips received by their employers via customers' charge accounts, "except those charge account tips included in employees' statements under Section 6053(a) of the Code."

It is the Institute's contention and the belief held by the industry generally, that application of this provision, beginning on January 1, 1979, will result in an administrative nightmare and a record-keeping burden of immeasurable proportions. Additionally, it will require the employer to point an accusing finger at his tipped employees, no matter how reliable, if the charge account tips reported to the employer do not equal the amount shown on the face of the charge account receipts. It will also, in many instances, create situations where cash wages of the tipped employees will not be sufficient to meet the employee's liability for income and Social Security taxes.

The problem was created on September 15, 1975 when the Internal Revenue Service issued Revenue Ruling 75-400 to require employers to report on employees' W-2 Forms any tip income paid over to the employees from tips added to a waiter's check by a charge customer. This ruling was later modified by Revenue Ruling 76-231 released May 26, 1976. The modification, however, did not change the impact or effect of the preceding ruling.

Prior to the issuance of the IRS rulings, and under Section 6053(a) of the Internal Revenue Code, employees were required to report to their employers all tips received usually on a monthly basis. The employers, in turn, were required, under Section 6051(a) of the Code, to report as wages only tips actually reported to them by their employees. It was only this amount of tips that was subject to withholding for income and FICA purposes.

The Revenue Rulings were issued after the House had already completed action on Bill H.R. 10612, which later became Public Law 94-455. The Senate, however, had an opportunity to consider the Revenue Rulings and the Senate Finance Committee nullified them by amending the bill to specify that the only tips which an employer must report to the IRS are those tips reported to the employer by the employee. Under the Committee amendment employers were not required by law to keep records or accounts of employees' charge account tips or to report those to the IRS.

The Senate's reasoning behind the amendments was stated fully in Senate Report No. 94-938, pp. 416-417, as follows:

"The requirement that employers report to the IRS charge account tips not reported to them by their employees appears to entail burdensome record-keeping requirements for many employers. As a matter of general practice, charge account tickets are turned over by, for example, a waiter to the business manager, who then, or shortly thereafter reimburses the waiter from the cash register or other ready cash for the amount shown on the charge ticket which represents the waiter's tip. However, at the end of an accounting period, employers may have only a record of total charge account tips, and do not necessarily have any way of breaking down that total per employee. In order to determine the amount of charge account tips received by each employee, such employers must go back to allocate each charge ticket to the employee responsible for it, if that employee's identity is identifiable from the charge ticket.

"The committee believes that the practices presently followed by employers in reporting their employees' tips to the Service is appropriate and that the new rules proposed by the Service present an unnecessary complication for employers. The committee provision nullified the recent IRS ruling relating to charge tips."

The amendment prevailed as the Senate passed the measure. However, the Conference Committee modified the provision providing that the effect of the Revenue Ruling would commence on January 1, 1979 and in the rush toward adjournment, the bill was enacted despite a body of past legislative history that the approach was a confusing and unworkable one.

In 1965, when Congress considered the Social Security Act Amendments of 1965 (H.R. 6675), it was their intention to extend Social Security benefits and coverage to tip income. In reporting the measure, however, the House Education and Labor Committee wrote:

"The problem of extending social security coverage to tips has engaged the attention of your Committee for many years. The principal difficulty has been to devise a fair and practical system for obtaining information on amounts of tips received by an individual which could serve as a basis for contributions and benefit credits." (H. Rep. No. 213, 89th Cong., 1st Sess.)

That same report points out emphatically that employers, in fulfilling their new obligations with respect to social security and income tax withholding, should not be burdened with the role of watchdogs over their employees.

This new law, when effective, will not only make employers of tipped employees watchdogs, it will also make them reluctant informants to the detriment of any employer-employee relationship which has been allowed to develop. Employers will be required to report discrepancies to the IRS. In some instances these reports will be forwarded to the IRS without the knowledge of the employee. In many instances there could be substantial liability for employers who erroneously attribute tip income to the wrong employee.

In the food and lodging industry, the practice of tip pooling and/or splitting is an every-day event. There are numerous pooling and splitting arrangements to allocate tips among waiters and waitresses, bus boys, wine stewards, hostesses, etc., the details of which are generally unknown to employers.

Even if the employer has specific knowledge of such an arrangement, he is barred by the Fair Labor Standards Act of 1938 from controlling the arrangement or dictating among whom the tips will be split. Amounts paid over to employees from charge slips therefore do not necessarily represent income to the employees to whom they are paid. As with cash tips, they may be pooled.

Mr. Chairman, we urge consideration of our comments and a change in the law. The financial impact is small by IRS standards. In its report on the 1976 bill, this Committee estimated that it would result in reduced tax receipts of less than $5 million. That will be much less than what it will cost the industry in time, bookkeeping and record-keeping and we cannot put a price tag on employee morale.

In summary, Mr. Chairman, we urge rejection of the President's proposal to restrict the deductibility of business meals and urge the Senate once again to relieve the industry of the excessively burdensome record-keeping anticipated with respect to charge account tip reporting.

Thank you.

STATEMENT OF WILLIAM G. GIERY, EXECUTIVE SECRETARY, FOODSERVICE AND LODGING INSTITUTE BEFORE THE FINANCE COMMITTEE, U.S. SENATE, AUGUST 22, 1978

Mr. Chairman and members of the Finance Committee, I am William G. Giery and I am executive secretary of the Foodservice and Lodging Institute.

The proposed jobs tax credit drafted by the House Ways and Means Committee and passed recently by the House of Representatives, is the first positive step Congress has taken to utilize private industry to procure jobs for those considered hard-to-employ, a plan that we have been advocating for years without much success.

We have analyzed the House-passed proposal and while we endorse the proposal enthusiastically we also believe that the targeted groups, for which the tax credit would apply, be broadened to include teenagers between the ages of 16 and 19, the hardest-hit age group in the employment market. Black or whte, oriental, hispanic, or American Indian, the American teenager is the most discriminated class in the job market. There are no race barriers, nor creed barriers. They are all discriminated against. While the nation is fighting back from the massive unemployment experienced in 1976 and early 1977, teenage unemployment still remains embarrassingly and tragically high. A slight reduction in July when teenage unemployment dropped from 16.5 percent to 14.2 percent was all but wiped out in August when the figure climbed again to 16.2 percent. To further erode the confidence of our nation's youth, it is a sad commentary that more than one out of every three black teenagers (37.1 percent) cannot get a job in today's labor market.

Economists have many theories as to the causes of teen unemployment but very few solutions are voiced. Comments have been voiced repeatedly, both in this chamber and in the House of Representatives that while public service employment and training programs are all but failures, proposed youth employment legislation foresees only major expansions of the same programs that have not improved the employability of youth.

Now the Senate has an opportunity to silence these critics. It has an opportunity to expand the House-passed jobs tax credit to include teenagers as a targeted class. It is the private sector which has the longest history of effective training and placement and it is time to encourage private industry to hire our nation's youth. Failure to enlist support of private industry, through this tax credit, will not only allow the youth unemployment problem to continue but could also destine the current generation of youth to a lifetime of unemployment. The proposed jobs tax credit for targeted groups is a good proposal. We urge you, however, to make it better by including as a class, our nation's almost forgotten teenagers.

Before we close, Mr. Chairman, I would appreciate the opportunity to make a few observations about another provision in President Carter's tax reform package: The proposal to make the present 10 percent investment credit permanent and to extend the credit to construction and rehabilitation of manufacturing and utility buildings.

We are elated with the news that the House Ways and Means Committee modified the President's proposal and extend the credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of businesses including retail.

I am not a tax expert nor do I pretend to be one. I do know that the investment tax credit is designed to spur capital formation which in turn will spur employment. We believe that this credit. should be extended to construction or rehabilitation of all buildings including restaurant and hotel construction. This should be done to recognize the fact that millions of jobs could be provided in the food and lodging industry.

We know that since enactment of the credit, hundreds of thousands of jobs have been created in manufacturing industries. Many of these jobs. however, went to skilled craftsmen while those who needed jobs—the entry-level employee and then nation's youth—were left wanting. It is our industry which has provided jobs for the unskilled, the semi-skilled and the nation's youth. The jobs that we provide to the seemingly unemployable transforms tax burdens into taxpayers.

Finally, we understand that the distinguished chairman of this Committee is considering a provision to broaden the extra investment credit for corporate taxpayers making Employee Stock Ownership Plan (ESOP) contributions.

Several of our members have adopted ESOP's but many have been hesitant because the additional 1% credit now available is not a permanet part of the Code. Further, in the case of the extra one-half percent for employer-matched employee contributions, the qualifications are confusing, complicated and cumbersome to the extent that it is not fully utilized.

We recommend that the Committee adopted a two percent investment credit where contributions are made to a qualified ESOP and that the credit be made a permanent part of our tax system. The advantages of this would be numerous. It would encourage more companies to adopt ESOP plans; it would provide more employees with an opportunity to purchase stock; it would generate capital formation; and most importantly it would simplify the present provisions of the law.

Thank you.

[Whereupon, at 4:08 o'clock p.m., the committee recessed subject to a call of the Chair.]

APPENDIX

NATIONAL ASSOCIATION OF MANUFACTURERS,
Washington, D.C., September 6, 1978.

Hon. ABRAHAM RIBICOFF,
U.S. Senate, Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR RIBICOFF: During my appearance on the first panel before the Senate Finance Committee's August 21 hearing concerning HR 13511, you asked for the comments of business community witnesses on what Congressional action could be taken to improve U.S. productivity, to restrain inflation, to increase U.S. exports and to strengthen the dollar. As you prepare to draft a major tax reduction bill which can impact all of these matters, I would like to reiterate the view of the National Association of Manufacturers and of myself as the owner/manager of a small business on federal tax policy as it affects our economy. I am taking the liberty of sending a copy of this letter to your Committee colleagues.

Tax policy has not created our current problems single-handedly, and the pending tax bill alone cannot root out all of their causes. I believe that this fact is widely recognized in the business community, and we do not want to overstate the case for tax reductions. But, our income tax structure *has* created both practical obstacles and psychological barriers to the capital formation and business investment needed to overcome these problems. In the context of the pending tax bill, the four areas outlined below should be considered by the Committee as ways of minimizing these obstacles.

The number one priority should be a significant reduction in the corporate tax rate. NAM favors a three percentage point reduction and an increase in the corporate surtax exemption to $100,000 in 1979, followed by an additional three percentage point reduction over a three-year period with further increases in the surtax exemption. The six-point cut would be a significant reduction of the current high cost of capital, and it would benefit firms in all sectors of the economy. Business planners could consider the future with some measure of confidence and anticipate that investments made now would produce future income which would bear a smaller tax cost. This anticipation of the future would have a dramatic effect on investment next year, even though the rate cut would not be completely effective until 1982.

A significant increase in the surtax exemption, coupled with a general rate reduction, would greatly assist small and growing firms to generate the capital needed to employ more people productively and to continue their role as major innovators in our economy. On behalf of the approximately 80% of NAM's 12,400 members which are small businesses, I particularly urge enactment of a reduced corporate tax with only two rates and a much higher surtax exemption.

We recognize that such significant corporate rate cuts might be viewed as providing too much tax relief to business. However, I want to re-emphasize the testimony which I presented regardng the econometric "feedback analysis" outlined in Appendix B of my August 21 written statement. Dollar-for-dollar of static estimate revenue loss, a corporate rate cut generates a larger increase in business investment and a greater net revenue feedback to the Treasury than does an individual rate cut. Therefore, at this time when there is much concern over lagging capital spending and the size of the federal deficit, a sizable corporate rate cut is particularly appropriate.

The investment tax credit should be stabilized and its usability increased. The roller coaster history of the investment credit is its major weakness. A permanent extension of the 10% rate and the $100,000 used property limitation would lend a somewhat more stable appearance to the credit. An immediate

increase in the 50% income tax liability limitation to 90% would enhance its effectiveness for many companies, particularly those whose capital expenditures have an immediate beneficial effect on the economy.

The Administration's "reform" proposals affecting "deferral" and DISC should be set aside. The competitiveness of U.S.-owned firms in foreign markets and of U.S. goods in export trade should not be attacked, particularly during this period of weakness in the dollar and massive trade deficits. The overseas subsidiaries of U.S. firms contribute substantial sums to the positive side of our balance-of-payments, some $24 billion during the last three calendar years alone. Imposing punitive taxes on such operations by ending "deferral" could only have an adverse effect on our balance-of-payments. The DISC provisions are essential to the competitiveness of many U.S. exports. The export activities of small businesses in particular are encouraged by DISC. Raising the cost of such exports by repealing or restricting DISC would not enhance our overall export situation.

The tax burden on capital gains should be reduced generally. In addition to the tax reductions which affect business directly, the tax applied to capital gains should be cut significantly to reduce this major barrier to new investments by individuals. The tax rate applied to corporate capital gains also should be reduced. HR 13511 has made a good first step in the capital gains area, but it should not be viewed as the ultimate answer. A larger reduction in this tax on capital can encourage the return of small investors to the equity markets, thereby directing much needed capital into the corporate sector.

You and your colleagues now have the opportunity to draft a major tax bill which can favorably affect the climate for productive investment. This, in turn, can impact U.S. productivity and the general rate of inflation, with further beneficial effects on exports and the strength of the dollar. We urge you to seize this opportunity and to maximize its use.

Sincerely,

ROLAND M. BIXLER,
Chairman, Committee on Taxation.

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